Solutions in a Flash – Whoops! Deferral Errors!

7/28/2021 Update:

With the release of Revenue Procedure 2021-30, effective 7/16/2021, the IRS has reinstated the safe harbor for correcting automatic enrollment failures without requiring the funding of QNECs. This safe harbor correction method will expire December 31, 2023.

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Administering a 401(k) plan is not an easy job. Two common errors that plan sponsors make with elective deferral (also known as salary deferral) contributions are when they fail to implement an employee's election (so that intended deferrals are not made), or they process the election incorrectly so that the wrong amount is withheld from the employee's paycheck and deposited to the plan.

When this happens, the employee has missed a deferral opportunity. This means that the employee was taxed on compensation that was supposed to be deferred, and the contribution failed to earn an investment return in the plan.

But fear not, you are not alone in this struggle. Here we discuss how to fix elective deferral contribution mistakes.

Failure to Implement a Deferral Election

Let's say that Natasha starts working at ABC Corporation, which sponsors a 401(k) plan. The plan provides for matching contributions for eligible employees equal to 100% of elective deferrals up to 3% of an employee's compensation. On December 29, 2017, Natasha makes her first election to contribute 5% of compensation for the 2018 plan year, when she becomes eligible. Her salary was $50,000 for the year. The HR manager was out on maternity leave when Natasha submitted her forms, so Natasha's election was never processed. Close to the end of 2018, Natasha finally notices on her paycheck stub that her deferrals were never deducted from her paychecks. What does HR do now?

- ***Elective Deferrals***

Believe it or not, this is actually a very common failure. Under the IRS's correction procedures (called the "Employee Plan Compliance Resolution System" or "EPCRS," and found in Revenue Procedure 2019-09), ABC Corporation must make a qualified non-elective contribution (QNEC) to the plan for Natasha equal to the missed deferral opportunity ("MDO"). The MDO varies, depending on when the error is found and whether the plan uses automatic enrollment. Here are the required QNECs under EPCRS:

Automatic Enrollment?	When Corrected	MDO and Required QNEC (as a percentage of the deferral the participant would have made)
Yes	On or before the first payday of the month after the month of discovery, but not later than 9½ months after the end of the plan year in which the error first occurred	0%
No	On or before the first payday of the month after the month of discovery, but not later than 3 months after the error first occurred	0%
Applies regardless of automatic enrollment	On or before the first payday of the month after the month of discovery, but not later than 3 years after the end of the plan year in which the error first occurred	25%
Applies regardless of automatic enrollment	After above deadlines	50%

If Natasha's missed deferral was found at the end of 2018, it is more than three months after the error first occurred, but within the plan year of the deferrals. Therefore, the QNEC rate is 25% (assuming that the plan does not use automatic enrollment). Natasha's missed deferral is equal to her elected deferral percentage (5%) for 2018, multiplied by her compensation for that year ($50,000), or $2,500. That amount is then multiplied by the applicable percentage (25%). Thus, the plan sponsor must contribute a required QNEC for the failure to implement Natasha's deferral election of $625 (adjusted for earnings).

- ***Matching Contributions***

The next step is to calculate missed matching contributions that Natasha was eligible for and missed because her election was never processed. ABC Corporation also must contribute a matching contribution to the plan on Natasha's behalf equal to the matching contribution Natasha would have received (adjusted for earnings) if the missed deferral was made like it was supposed to be. As noted above, the missed deferral was $2,500, 5% of Natasha's compensation. The plan provides for a 100% matching contribution up to 3% of pay. Three percent of Natasha's compensation is $1,500 ($50,000 x .03). The match is, therefore, the lesser of these two amounts, or $1,500. Thus, ABC Corporation is required to contribute $1,500 (adjusted for earnings) to the plan on behalf of Natasha.

- ***Employee Notice***

Additionally, the employer must send a notice of the failure to the affected participant no later than 45 days after the employer implements the participant's deferral election. The content of the notice requirement is found in section .05(8)(c) of Appendix A in EPCRS.

Processing Incorrect Elective Deferral Contributions

Under the second failure, the plan sponsor deposited a deferral for the employee – but it was for the wrong amount! This commonly happens when there is an error made in processing the election or the plan sponsor fails to implement a change in the participant's election.

- ***Deferral Election Less Than What It Should Be***

If the plan sponsor has removed too little from the participant's paycheck, the same rules and correction methods discussed above apply, but only to the missed amount. The plan sponsor should make a corrective QNEC contribution for the difference between the amount that should have been deposited and the amount that was actually deferred, multiplied by the applicable percentage from the chart, based on the timing of the discovery of the error. Additionally, the plan sponsor would contribute to the plan the missed additional matching contribution that the employee would have had, had the deferral amount been what was intended.

- ***Deferral Election More Than What It Should Be***

In this case, the plan should return the excess contributions that were inappropriately withheld. This option will require the plan to issue a Form 1099-R to the participant with Distribution Code "E" in Box 7 for other distributions checked off so the participant does not have to pay the 10% tax penalty.

If the error is caught early enough and the participant is still employed with the company, the plan sponsor may be able to decrease the participant's contribution for the rest of the year to "even out" the total contributions (thereby avoiding the need to actually refund money and issue a Form 1099R. However, the plan sponsor still must confirm that the participant's matching contribution is calculated correctly, so that they receive a match equal to what they would have received if the correct deferral election was properly implemented.

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