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KRAVITZ Retirement Plan News

Relief for elective deferral failures

An elective deferral failure occurs when a plan sponsor fails to correctly implement an elective deferral. This includes deferrals participants "elect" to make (affirmative elections) and deferrals based on a plan's automatic contribution features (including automatic escalation).

An elective deferral failure also occurs if a plan sponsor fails to provide an employee with the *opportunity* to make an affirmative election because the employee was improperly excluded from the plan.

An EPCRS update

The IRS received comments that said the existing elective deferral correction rules overcompensate participants when deferral failures last for short periods. The IRS also received feedback indicating that high costs related to correcting elective deferral failures in automatic contribution arrangements were discouraging employers from adopting automatic contribution features (e.g., automatic enrollment and automatic escalation). In response, the IRS released Revenue Procedure 2015-28, which presents three new methods for correcting elective deferral failures in 401(k) and 403(b) plans. This is an update to its Employee Plans Compliance Resolution System (EPCRS).

Comparing the rules

Prior to the changes introduced by Rev. Proc. 2015-28, the missed deferral opportunity cost was generally based on 50% of the missed deferral. But it was also based on the type of failure:

- When a participant was improperly excluded, the missed deferral cost was 50% of the missed deferral, based on the average of the actual deferral percentage for the group the participant was in (highly compensated or non-highly compensated employees).
- For safe harbor 401(k) plans, the missed deferral cost was 50% of a 3% deferral. For a safe harbor plan with an enhanced match, the missed deferral was 50% of the percentage that receives a dollar-for-dollar match.
- When a participant filed a salary deferral election that was not implemented, the correction was 50% of the amount the participant elected.
- When an eligible participant failed to be automatically enrolled, the missed deferral cost was 50% of the deferral that should have occurred.

Note: There was an exception to the missed opportunity cost outlined in the bullet points if there were at least nine months of the plan year remaining after deferrals started.

If the plan called for matching contributions, the employer contributed an amount equal to the total matching contribution the participant would have received had his or her deferrals been handled correctly.

There are three new rules under Rev. Proc. 2015-28:

I. There will be no missed deferral opportunity cost for automatic enrollment or automatic increase (escalation) failures that are found and corrected by the first payroll date after the earlier of:

- Nine and a half months after the end of the plan year in which the

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automatic contribution or increase should have occurred, or

- The last day of the month following the month in which the participant advises the sponsor of the problem.

Example 1: An individual became eligible to participate in his or her employer's plan on July 1, 2015, and the plan administrator failed to automatically enroll the individual. This error is discovered on February 1, 2016, by the plan administrator. The individual is automatically enrolled in the plan on the next payroll date and is provided with a notice of the failure within 45 days of the elective deferral beginning. No corrective contribution is required because the error was discovered within nine and a half months after the end of the plan year in which it occurred, and the corrective action was made in a timely manner.

II. The missed deferral opportunity cost for errors in implementing affirmative elections, automatic enrollment, and automatic increases discovered within three months:

There will be no employer corrective contribution required for missed deferrals that happened within the prior three months (this is a "rolling three-month period") if deferrals are restarted by the first payroll date after the earlier of:

- Three months after the missed deferrals occurred, or
- The last day of the month following the month in which the individual advises the sponsor of the problem.

Example 2: An individual became eligible to participate in his or her employer's plan on July 1, 2015, and the plan administrator failed to automatically enroll the individual. This error is discovered by the individual on August 10, 2015. After informing the plan administrator of the error on August 10, the individual is automatically enrolled in the plan on August 28, 2015. No corrective contribution is required because the error was less than three months in duration, and the elective deferrals began before the end of the month after the month the plan sponsor was notified of the problem. Also, the individual was provided with a notice of the failure within 45 days of elective deferrals beginning.

III. The missed deferral opportunity cost for errors in implementing affirmative elections, automatic enrollment, and automatic increases found within the EPCRS Self-Correction Program (SCP) correction period for significant errors (i.e., the last day of the second year following the plan year in which the error occurred):

The employer corrective contribution required for missed deferrals is reduced from 50% to 25% for missed deferrals that fall outside of the time periods given in the prior examples but are corrected by the last day of the second year following the plan year in which the error occurred.

Example 3: An individual became eligible to participate in his or her employer's plan on June 1, 2015, and completed and submitted a salary deferral election form for 6% of compensation on the same day. The plan administrator failed to enroll the individual. There is a 50% match on deferrals up to 6%. The error is discovered by the participant on January 28, 2016, and the individual is enrolled in the plan on the next payroll date. The plan administrator is required to make a corrective contribution under EPCRS because the error was not discovered within three months. However, the missed opportunity corrective contribution will be 25% of 6% of compensation, or 1.5% of compensation, plus earnings (rather than 50% of 6%) because the failure error lasted longer than three months and the correction is being made within the SCP correction period for significant errors. There is also an employer corrective contribution required for the associated match: 50% of 6% from June 1, 2015, until the date the corrective contribution is made plus earnings. Depending on plan design, the corrective matching contribution may be made as a qualified nonelective employer contribution (QNEC), a qualified matching contribution (QMAC), or an employer matching contribution. If the employer matching contribution is selected, it may be subject to the employer's vesting schedule.

Note: The difference between Example 3 and Example 1 is that Example 3 did not involve an automatic enrollment situation. Rather, the deferral election the participant filed was not implemented, so the nine and a half month period was not applicable.

Under all these new correction methods, the employer must also:

1. Make a matching contribution in the amount the participant would have received had the deferrals been handled correctly in the first place,
2. Provide a notice to the affected participants within 45 days of the date on which the proper deferrals started occurring, and
3. Calculate (and contribute) lost earnings for any corrective contributions the employer is required to make.
   - For automatic enrollment failures where no investment election has been filed, earnings may be calculated using the earnings rate of the plan's default investment. (This is a new earnings calculation method.)
   - For other missed deferral failures, the earnings are based on one of the four existing earnings calculation methods found in EPCRS Appendix B, Section 3.

Note: If the investment suffered a net loss, the loss may not reduce the required corrective contribution.

Failure to implement elective deferrals in automatic contribution feature

The guidance states that the automatic contribution corrections above will apply to these types of failures that occur between now and December 31, 2020. The IRS will then consider whether to extend them by taking various factors into consideration, including whether there is an increase in the number of plans that implement automatic contribution features.

Back to basics: Eligibility

Federal law sets eligibility requirements for when employees can begin participating in an employer's plan. In general, a plan may require that employees be at least 21 years old and complete a year of service before they are eligible.

A year of service generally requires employees to complete 1,000 hours of service over a 12-consecutive-month period. Note that plan sponsors may design plans with less restrictive eligibility requirements that will allow earlier entry into the plan.

1,000-hours-of-service eligibility rule

If a plan requires employees to complete 1,000 hours of service in a 12-month period to be eligible to participate, are employees eligible to join as soon as they complete the required 1,000 hours of service?

No. The law requires employees to complete 12 months of service first. Then, a determination is made as to whether or not they have been credited with 1,000 hours of service. Pension geeks call this the statutory eligibility rule because it is based on statute, specifically Internal Revenue Code Section 410(a)(3)(A) and ERISA Code Section 202(a)(3)(A).

Example: The sponsor of a plan with a 1,000-hours-of-service eligibility requirement hires an employee on November 11, 2015. The plan has semi-annual entry dates of January 1 and July 1. The employee completes 1,000 hours of service on June 8, 2016, but is not eligible to join the plan at that time or on the next entry date of July 1, 2016. He or she must wait until November 11, 2016, to complete the 12-months-of-service requirement. Since the employee has already completed 1,000 hours of service, he or she will be eligible to enter the plan on the *next* plan entry date (January 1, 2017).

Although some employers may consider it an act of generosity to permit earlier entry, the law requires that employees reach the anniversary of the day they first performed an hour of service *and* be credited with 1,000 hours before joining the plan. Again, if the employer wants to allow a shorter eligibility period and earlier entry, the plan may be designed to allow that, but this example is for plans that use the 12-month, 1,000-hour rule.

Though the service computation period is a 12-consecutive-month period, the period may include times when the employee leaves employment and is subsequently rehired. In this situation, the employment periods will be linked, provided the employee does not have a break in service. (A break in service is defined as a 12-month period during which the employee is not credited with at least 501 hours of service.)

Note: Since an employee may return to employment at a later date, plans should determine whether or not employees have satisfied the 1,000-hour requirement on the anniversary of their employment, even if they are not employed at that time. Those who have will be eligible to enter the plan upon being rehired or shortly after.

Elapsed-time eligibility method

The elapsed-time method for determining plan eligibility is an alternative to the hours-of-service method. The elapsed-time method does not count the actual or equivalent hours worked but instead measures the period of time that begins on the employee's date of hire and continues through the date the employee meets the plan's eligibility requirements. An employee who is hired on April 15, 2015, and is still employed on April 15, 2016, is considered to have completed one year of service under the elapsed-time method, regardless of the actual number of hours worked during that measuring period.

This method works well for employers who wish to simplify the administrative process of including employees in jobs where counting hours is not always easy or possible (e.g., construction workers, truckers, etc.). However, if the employer's goal is to *exclude* any of these categories of jobs from plan participation, the hours-of-service method would be a better choice since employees may be required to complete as many as 1,000 hours of service in a year to become eligible.

The service spanning rule

Under the elapsed-time eligibility method, absences of less than 12 consecutive months are not counted against an employee under the service spanning rule. A break in service (called a "period of severance" for elapsed-time purposes) only occurs if there is an absence of 12 or more consecutive months.

Example 1: A plan has a one-year elapsed-time eligibility requirement. An employee is hired on April 15, 2015, quits on July 26, 2015, and is rehired on February 10, 2016. Under the elapsed-time method, the employee satisfies the one-year service requirement because his absence was less than 12 months, and he is employed on April 15, 2016, the anniversary of his date of hire. The actual number of hours worked is irrelevant.

Example 2: A plan has a one-year elapsed-time eligibility requirement. An employee is hired November 8, 2014, and works until September 17, 2015. The employee leaves and is rehired December 8, 2015. Because she did not have a 12-consecutive-month absence, the employee is considered to have satisfied the elapsed-time one year of service (November 7, 2015) upon rehire. If a participant's normal entry date into the plan passes during his or her period of absence, the employee is eligible to join the plan immediately upon being rehired, provided there has not been a 12-consecutive-month absence.

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RECENT developments

Form 5500-EZ

In June of 2014, the IRS launched a one-year pilot program providing penalty relief for delinquent Form 5500-EZ filers. On June 3, 2015, the IRS announced that the one-year free pilot program has been replaced by a permanent program (Revenue Procedure 2015-32). Form 5500-EZ may be filed by plan sponsors of "one-participant" plans (and certain foreign plans).

To qualify for this program, the plan sponsor must file all the delinquent Form 5500-EZ returns and pay a filing fee of $500 per return up to a maximum of $1,500 per plan, regardless of how many late forms are filed. The IRS has noted that late filers may request relief from late-filing penalties due to reasonable cause by attaching correspondence to the applicable delinquent return. The plan sponsor is not eligible for the program if the IRS has already assessed a late-filing penalty.

Preapproved document changes

In Revenue Procedure 2015-36, the IRS added cash balance plans and employee stock ownership plans (ESOPs) to its preapproved plan program for master and prototype and volume submitter plans. It also extended the application deadline for submitting the current round of Pension Protection Act of 2006 (PPA) preapproved defined benefit (DB) plans from June 30, 2015, to October 30, 2015. The extension gives drafters an opportunity to incorporate cash balance plan language into the PPA round of preapproved DB plans. Historically, IRS review and approval takes about two years from the application submission date. Therefore, preapproved PPA DB documents may not be available until the latter part of 2017 or perhaps 2018.

Drafters of preapproved defined contribution (DC) plan documents will be able to include ESOP provisions in the next round, i.e., the round *after* the PPA documents. The next six-year DC plan cycle opens on February 1, 2017, which means the next preapproved DC plans will generally not be available until sometime in early 2020.

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