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The IRS is Back with Some Brand New Corrections

Let's face it. Finding out that the IRS wants to poke around is not going to be the highlight of anyone's day. Voluntarily admitting a mistake to the IRS and asking for forgiveness is probably even lower on the wish list! So hearing about new voluntary corrections from our friends at the Service might seem like a waste of time.

Not so fast! Believe it or not, the division of the IRS responsible for qualified retirement plans actually does not want to find problems and hand out sanctions. Their goal is to help preserve tax-favored retirement benefits that exist within retirement plans. Of course, if someone doesn't play by the rules, they shouldn't then be able to claim the same benefits as someone who does satisfy the various requirements.

That is where the various voluntary correction programs come into play. The IRS recognizes that there are a lot of moving parts involved in the proper care and feeding of a retirement plan. More than 20 years ago, they created the first iteration of a program that allowed companies to voluntarily get their plans back on track, provide participants with any missed benefits and avoid most, if not all, of the penalties the IRS might otherwise assess. Over the last two decades, the IRS has continued to evolve, update and consolidate these programs to make them more accessible and meet the needs of an evolving business climate.

That evolution continued earlier this year when the IRS expanded the correction options for situations when participants are not signed up to make 401(k) deferrals when they are supposed to be. The Service also finalized a pilot program for certain single-participant plans that file their Forms 5500-EZ after the deadline. Let's take a look.

Missed 401(k) Deferrals

The "Old" Rules

For the last several years, the "standard" correction for not timely enrolling an employee in the 401(k) plan has been a five-step process:

1. Determine how much the employee would have deferred—referred to as the missed deferral opportunity;
2. Calculate a corrective qualified nonelective contribution equal to 50% of the missed deferral opportunity;
3. Calculate the related matching contribution using 100% of the missed deferral opportunity;
4. Adjust the qualified nonelective contribution and match for investment gains; and
5. Deposit the sum of steps 2, 3 and 4 into the participant's account in the plan.

Prior to 2008, the qualified nonelective contribution in step #2 was required to be 100% of the missed deferral opportunity, so the reduction to 50% was a welcome change.

The IRS provides guidelines for determining how much the employee would have deferred. For example, if an employee enrolled but the enrollment was never implemented, the missed deferral opportunity is based on the actual enrollment. If the employee wasn't given the opportunity to enroll, the missed deferral opportunity is equal to the average of the employee's group (either highly compensated or non-highly compensated). There are several other parameters for different situations, but we will spare you those gory details here.

Fortunately, this correction methodology is still completely acceptable. In a Revenue Procedure published in the spring of this year, the IRS provided a couple of new options for correcting missed deferral opportunities, one for automatic enrollment plans and one for traditional 401(k) plans.

Before getting into some of the details, it is helpful to note that the new options only apply to the calculation of the qualified nonelective contribution (step #2, above). Any missed match must still be corrected as noted in step #3, i.e., applying the match formula to the full amount the participant would have deferred if timely enrolled.

It is also worth noting that unless the plan's investments suffered a loss for the time period in question, corrective contributions must always be adjusted to compensate for lost investment earnings.

New Option for Traditional Enrollment 401(k) Plans

For traditional plans that require participants to make an affirmative deferral election, the new option creates a rolling three-month correction window. In a nutshell, if the participant in question is properly enrolled and has deferrals withheld no later than three months following the initial failure, then no qualified nonelective contribution is required. If correct deferrals begin after more than three months but less than two years, the qualified nonelective contribution is reduced to 25%.

There are a couple of small strings attached. The first string is that if the missed employee catches the problem earlier than three months after the initial failure, the company must implement the correct deferrals no later than the first pay period of the month after the employee brings it to the company's attention. In other words, the company can't sit back and say, "Bummer, but we can wait up to three months before we do something about it." Seems like that would have been obvious, but they probably have to plan for that one person who tries to get snarky.

The second string is that the company must provide written notice of the failure to all affected participants. More on that later.

New Option for Automatic Enrollment 401(k) Plans

Ever since Congress passed the Pension Protection Act of 2006, automatic enrollment has become an increasingly popular concept. One of the challenges in getting it from concept to implementation has been the fact that it is easy for new hires to fall through the cracks, especially in plans that have eligibility requirements that extend beyond a month or two after date of hire. And it has been a pain in the neck to go through the corrective calculations every time it happens.

In response to that concern, the IRS also created a new correction for automatic enrollment plans. As long as the failure to automatically enroll a participant on a timely basis is caught and correct deferrals withheld no later than 9½ months after the close of the plan year of the failure, then no qualified nonelective contribution is required. In addition, if the participant did not

make an investment election, the lost earnings calculation for the match can be determined using the plan's qualified default investment alternative.

The same strings are attached. Specifically, the correct deferrals must begin earlier if the participant in question brings it to the company's attention, and the company must provide written notice to the impacted participants.

The Notice

It seems like every new rule in the last 10 years has been accompanied by a notice, and this change is no exception. Fortunately, this notice is relatively straightforward. In order to take advantage of either of the new options, the sponsor must provide a notice to all impacted participants no later than 45 days following the date correct deferrals begin that provides:

- General information about the failure;
- A statement that correct deferrals are now being withheld;
- A statement that corrective matching contributions (if the plan provides for one) have been made;
- An explanation that the participant may increase deferrals to make up for those that were missed; and
- Plan contact information.

Is There a Catch?

Some may wonder why a company wouldn't take advantage of the new correction options. I mean both of them are less expensive than the standard 50% qualified nonelective contribution. There are several reasons that come to mind, both related to the notice. First, some companies may be reluctant to provide to employees a written statement of an error involving payroll and retirement accounts, especially in a case of already strained employee relations.

The second relates to the timing of the notice. If a company catches the failure and starts withholding the correct deferrals but doesn't provide the notice within 45 days, they are no longer eligible for the reduced qualified nonelective contribution and must revert to the 50% level.

Late Filing of Form 5500-EZ

Most retirement plans are required to file a Form 5500 each year, and the deadline is the end of the 7th month following the close of the plan year (July 31st for calendar year plans). The deadline can be extended by 2½ months (to October 15th for calendar year plans) by filing Form 5558. Hefty penalties could apply ($1,100 per day to the Department of Labor and up to $15,000 to the IRS) for failure to file timely.

For many years, the Department of Labor has had a delinquent filer program that allowed late/non-filers to get caught up and pay a very reduced fee, as low as $750 in some cases. However, that program only applies to companies that must file a Form 5500-SF or Form 5500.

Plans that cover only the owner or partners of a business and their spouses do not normally file one of these forms. Instead they file Form 5500-EZ. If an EZ filer happened to be late, the only option has been to write a so-called "reasonable cause" letter to the IRS to ask them to accept the late filing and forego any fines.

In 2014, the IRS created a pilot program that formally addresses late filing of Form 5500-EZ. After running that program for a year and soliciting feedback from the community, the Service finalized the program earlier this year.

Under the permanent program an EZ filer, as described above, can submit delinquent returns for a plan and pay a reduced penalty of $500 per delinquent filing, up to a maximum of $1,500 per plan if more than three years of returns are submitted. The returns that are submitted must be the forms that applied for the year in question. There are certain limited exceptions that allow use of the current version of the Form 5500-EZ.

In addition, the submission must include a completed Form 14704, attached to the front of the oldest delinquent return in the package, along with a check payable to the United States Treasury for the reduced penalty amount.

The Revenue Procedure that described the correction program makes it clear that EZ filers still have the option to submit a reasonable cause letter in lieu of using the program. However, the IRS also makes it clear that if the reasonable cause is not accepted, the plan will no longer be eligible to use the delinquent filer program and will be assessed the otherwise applicable penalties. If past experiences with government agencies are any indication, they tend to be much less accepting of reasonable causes once there is a formal correction program available, so proceed along that route with caution.

Conclusion

Unfortunately, retirement plans are complicated and have many moving parts that can lead to the occasional OOPS! Fortunately, the IRS continues to provide newer and easier ways to correct many of the more common oversights that can occur without breaking the bank in the process. If you think there might be a mistake lurking in a dark corner of your plan, let your team of service providers know so that they can help you fix it voluntarily rather than after the IRS finds it.

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