401(k) Plan Potential Mistakes

---------Trends------------	---------------------------------------Tips---			
Potential Mistake	**How to Identify the Mistake**	**How to Correct the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
1) Has your plan document been updated within the past few years to reflect recent law changes? (More)	Review annual cumulative list published close to year-end to see if plan made all required law changes (e.g., Notice 2007-3). (More)	EPCRS Adopt amendments for missed law changes. Appendix D, Part II (More)	VCP Audit CAP (More)	Plan sponsors need to resort to a calendar (tickler) of when amendments must be completed. Review your plan document annually. Maintain regular contact with the company that sold you the plan. (More)
2) Are the plan's operations based on the terms of the plan document? Failure to follow plan terms is a very common mistake. (More)	Independent review of plan and its operation. (More)	EPCRS Apply reasonable correction method that would place affected participants in the position they would have been in if there were no operational plan defects. (More)	SCP* VCP Audit CAP (More)	Plan sponsors need to develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices). Due diligence on at least an annual basis to ensure plan terms are being followed. (More)
3) Is the plan's definition of compensation for all deferrals and allocations used correctly? (More)	Review the plan document. (More)	EPCRS Corrective contribution or distribution. (More)	SCP* VCP Audit CAP (More)	Perform annual reviews of compensation definitions and ensure that person in charge of determining compensation is properly trained to understand the plan document. (More)
4) Were employer matching contributions made to all appropriate employees under the terms of the plan? (More)	Review the plan document to determine the correct matching contribution formula and compare to what is used in operation. (More)	EPCRS Correction should be based upon the terms of the plan and other applicable information at the time of the mistake. (More)	SCP* VCP Audit CAP (More)	Contact plan administrators to ensure that they have adequate and sufficient employment and payroll records to make calculations. (More)
5) Has your plan satisfied the nondiscrimination tests (ADP and ACP)? (More)	Independent review of TPAs to determine if highly compensated and nonhighly compensated employees are properly classified. (More)	EPCRS Correction method for ADP/ACP test failures: Make qualified nonelective contributions (QNECs) on behalf of the nonhighly compensated employees	SCP* VCP Audit CAP (More)	Consider a safe harbor plan. Communicate with plan administrator to ensure proper employee classification. Ensure both you and the plan administrator are familiar with the terms of the plan. (More)

---------Trends------------	---------------------------------------Tips---			
Potential Mistake	**How to Identify the Mistake**	**How to Correct the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
		Appendix B (section 2.01) One-to-one correction method. (More)		
6) Were all eligible employees identified and given the opportunity to make an elective deferral election? (exclusion of eligible employees) (More)	Review plan document sections on eligibility and participation. Check with plan administrators to find out when employees are entering the plan. (More)	EPCRS 6.02(7), Appendix A (section .05), Appendix B (section 2.02) Employer must make a qualified nonelective contribution (QNEC) to the plan on behalf of the employee that compensates for the missed deferral opportunity. (More)	SCP* VCP Audit CAP (More)	Plan sponsors need to monitor census information and apply participation requirements. (More)
7) Are elective deferrals limited to the amounts under IRC section 402(g) for the calendar year and have any excess deferrals been distributed? (More)	Inspect deferrals amounts for plan participants to ensure that limits have not been exceeded. (More)	EPCRS Appendix A (section .04) Distribute excess deferrals. (More)	SCP* VCP Audit CAP (More)	Employers should work with plan administrators to ensure that the administrators have sufficient payroll information to verify that the deferral limitations of section 402(g) were satisfied. (More)
8) Have you timely deposited employee elective deferrals? (More)	Determine the earliest date deferrals may be segregated from general assets; compare that date with the actual deposit dates and any plan document requirements. (More)	Usually DOL through VFCP for prohibited transaction. May also be EPCRS. For both VFCP and EPCRS Deposit into the Plan's trust all elective deferrals withheld and applicable earnings resulting from the late deposit of amounts to the trust. (More)	SCP* VCP Audit CAP (More)	Close coordination with payroll provider to determine the earliest date the deferrals deposits can reasonably be segregated from general assets and then set up procedures to ensure deposits are made by that date. (More)
9) If the plan was top-heavy, were the required minimum contributions made to the plan? (More)	Review the rules and definitions for top-heavy found in your plan document. Make a determination whether your plan is top-	EPCRS Appendix A (section .02) Properly contribute and allocate the required	SCP* VCP Audit CAP (More)	A top-heavy test should be performed each year. (More)

---------Trends------------	-------------------------------------Tips--			
Potential Mistake	**How to Identify the Mistake**	**How to Correct the Mistake**		**How to Avoid the Mistake**
		Corrective Action	**Correction Program(s) Available**	
	heavy or not for each plan year. (More)	top-heavy minimum, adjusted for earnings, to the affected non-key employees. (More)		
10) Were hardship distributions made properly? (More)	Review all in-service distributions and determine that hardship requirements of the plan were met. (More)	EPCRS Appendix B, (Sec. 2.07) Amend plan retroactively to allow for hardship distributions. If impermissible hardship distribution, have participant return hardship distribution amount plus earnings. (More)	SCP* VCP Audit CAP (More)	Employers should be familiar with the hardship provisions included in their plan document and implement procedures to ensure that the provisions are followed in operation. Employers need to ensure that the plan administrators and payroll offices share information regarding hardship distributions that are made from the plan. (More)
11) Have you filed a Form 5500 series return and have you distributed a Summary Annual Report (SAR) to all plan participants this year? (More)	Find your signed copy of the return and determine if it was filed timely. (More)	File all delinquent returns. (More)	For Form 5500 filers, see DFVC→ DOL web site Form 5500-EZ filers must file and ask for abatement of penalties. (More)	Understand your filing requirement and know who filed and when. Don't assume someone is taking care of it for you. (More) See 401(k) Resource Guide - Plan Sponsors - Filing Requirements

*** In order to utilize SCP, the plan sponsor must have established practices and procedures reasonably designed to promote and facilitate overall compliance with applicable Internal Revenue Code requirements. Also, an analysis of whether mistakes in the aggregate are significant or insignificant needs to be made. If insignificant, correction generally can be made at any time. However, if the mistakes are significant in the aggregate, then the plan sponsor only has two years following the year in which the mistake occurred to correct under SCP.**

401(k) Plan - Overview

Generally, Section 401(k) of the Internal Revenue Code (Code) permits an employee to elect to have his/her employer contribute a portion of the employee's wages to a 401(k) plan on a pre-tax basis (elective deferrals). A 401(k) plan is also referred to as a cash or deferred arrangement, or CODA. A 401(k) plan may also include other types of employer and employee contributions.

Elective deferrals (also known as salary deferrals or salary reduction contributions) are not subject to federal income tax withholding at the time of deferral and they are not reflected as income on the employee's Form 1040, *U.S. Individual Income Tax Return*. For example, if a worker earns $25,000 in a particular year and elects to defer $3,000 into a 401(k) plan, only $22,000 will be recognized as income on that year's tax return. Although amounts deferred are not treated as current income for federal income tax purposes, they are included as wages subject to social security (FICA), Medicare and federal unemployment taxes (FUTA). Additionally, elective deferrals are always 100% vested, or fully owned by the employee.

Beginning in 2006, a 401(k) plan may permit an employee to irrevocably designate some or all of his or her salary deferrals under the plan as designated Roth contributions. Designated Roth contributions are salary deferrals that, unlike pre-tax elective deferrals, are currently includible in gross income. A designated Roth account is a separate account under a 401(k) plan to which designated Roth contributions are made, and for which separate accounting of contributions, gains, and losses is maintained. Designated Roth contributions are treated the same as pre-tax elective contributions for most purposes, including nondiscrimination testing.

A 401(k) plan can have an automatic enrollment feature. This feature permits the employer to automatically reduce the employee's wages by a fixed percentage or amount and contribute that amount to the 401(k) plan unless the employee has affirmatively chosen not to have his or her wages reduced or has chosen to have his or her wages reduced by a different percentage. These contributions qualify as elective deferrals. This is an effective way for many employers to increase participation in their 401(k) plans.

A 401(k) plan is a "qualified plan." A qualified plan is one that satisfies the requirements listed under section 401(a) of the Code. If a plan satisfies these requirements, contributions made by the employer to the plan may be currently deductible and such contributions ordinarily will not be included in employees' gross income until distributed from the plan. If a plan fails to satisfy any of these requirements, the plan becomes "disqualified" and the favorable tax benefits associated with these plans may be lost.

There are several types of 401(k) plans available to employers - traditional 401(k) plans, safe harbor 401(k) plans, and SIMPLE 401(k) plans. Different rules apply to each. The following is a brief description of each type of 401(k) plan:

Traditional 401(k) plans: A traditional 401(k) plan allows employees who have met the eligibility requirements of the plan to make pre-tax elective deferrals or designated Roth contributions to a 401(k) plan through payroll deductions (elective deferrals). In addition, employers have the option of making contributions on behalf of all eligible employees, making matching contributions based on employees' elective deferrals, making other nonelective contributions, or making any combination of these contributions. These employer contributions can be subject to a vesting schedule which provides that an employee’s right to employer contributions becomes nonforfeitable only after a period of time, or they can be immediately vested. Rules relating to traditional 401(k) plans require that contributions made under the plan meet specific nondiscrimination requirements. In order to ensure that the plan satisfies these requirements, the employer must perform annual tests, known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests, to verify that elective deferrals and employer matching contributions do not discriminate in favor of highly compensated employees.

Safe harbor 401(k) plans: A safe harbor 401(k) plan is similar to a traditional 401(k) plan, but, provided the safe harbor requirements are met, the employer does not have to perform the annual ADP or ACP nondiscrimination tests that apply to traditional 401(k) plans. If a plan satisfies the safe harbor requirements, the elective deferrals and matching contributions under the plan are considered to satisfy the ADP and ACP tests, respectively.

Generally, a safe harbor 401(k) plan must provide for certain minimal employer contributions that are fully vested when made. These contributions may be employer matching contributions, limited to employees who defer, or employer contributions made on behalf of all eligible employees, regardless of whether they make elective deferrals.

Employers sponsoring safe harbor 401(k) plans must also satisfy certain employee notice requirements. The notice requirements are satisfied if the employer provides each eligible employee with written notice of the employee's rights and obligations under the plan and the notice satisfies content and timing requirements.

In order to satisfy the content requirement, the notice must describe the safe harbor method used, how eligible employees make elections, any other plans involved, etc.

The timing requirement necessitates that the employer provide notice within a reasonable period before each plan year. This requirement is deemed to be satisfied if the notice is provided to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year. There are special rules for employees who become eligible after the 90th day.

A new kind of safe harbor plan is available beginning in 2008, which is an automatic enrollment safe harbor 401(k) plan. The rules for this new type of safe harbor plan, including the vesting rules for employer contributions will be different from the existing safe harbor 401(k) plan described above.

Both the traditional and safe harbor plans are for employers of any size and can be maintained by employers in addition to other retirement plans. It is important that you become familiar with your plan so that you understand the special rules that apply to you.

SIMPLE 401(k) plans: SIMPLE 401(k) plans were created so that small businesses could have an effective, cost-efficient way to offer retirement benefits to their employees. A SIMPLE 401(k) plan is not subject to the annual ADP and ACP nondiscrimination tests that apply to a traditional 401(k) plan. Similar to a safe harbor 401(k) plan, the employer is required to make employer contributions that are fully vested. This type of 401(k) plan is available to employers with 100 or fewer employees who received at least $5,000 in compensation from the employer for the preceding calendar year. In addition, employees that are covered by a SIMPLE 401(k) plan may not receive any contributions or benefit accruals under any other plans of the employer.

Employee Plans Compliance Resolution System (EPCRS) – Overview

If mistakes are made with respect to your 401(k) plan, you may utilize the IRS's Employee Plans Compliance Resolution System (EPCRS) to remedy your mistakes and avoid the consequences of plan disqualification. A correction for a mistake should be reasonable and appropriate. The correction methodology should resemble one already provided for in the Code and all applicable facts and circumstances should be considered. The EPCRS is set forth in Rev. Proc. 2006-27, 2006-22 I.R.B. 945. There are three components of EPCRS:

1) **Self-Correction Program (SCP) -** permits a plan sponsor to correct certain plan failures without contacting the IRS.
2) **Voluntary Correction Program (VCP) -** permits a plan sponsor to, any time before audit, pay a limited fee and receive the Service's approval for correction of plan failures.
3) **Audit Closing Agreement Program (Audit CAP) -** permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

A general description of each component of EPCRS is provided below:

SCP:

- In order to be eligible for SCP, the plan sponsor or administrator of a plan must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance with applicable IRS requirements. For example, the plan administrator of a Qualified Plan that may be top-heavy under Code § 416 may include in its plan operating manual a specific annual step to determine whether the plan is top-heavy and, if so, to ensure that the minimum contribution requirements of the top-heavy rules are satisfied. A plan document alone does not constitute evidence of established procedures.
- SCP is available for correcting operational problems only – that is, the failure to follow the terms of your plan. SCP is not available for other types of problems, such as the failure to keep your plan document up to date to reflect changes in the law.
- The plan sponsor effects correction using the General Correction Principles set forth in Rev. Proc. 2006-27.
- A plan sponsor that corrects a failure listed in, and in accordance with, the correction methods included in Appendix A or Appendix B of Rev. Proc. 2006-27 may be certain that the correction effected is reasonable and appropriate for the failure.
- If needed, the plan sponsor effects changes to its administrative procedures to ensure the failures do not recur.
- A plan sponsor may correct Significant Operational Failures within two years of the end of the plan year in which the Operational Failures occurred.
- If a plan sponsor does not correct Operational Failures in its plan(s) within the two-year self-correction period, the Self-Correction Program may be used if, considering all of the facts and circumstances, the failures, in the aggregate, are Insignificant Operational Failures.
- When using SCP, the plan sponsor should maintain adequate records to demonstrate correction in the event of an audit of the plan.
- There is no fee for self-correction.

VCP:

- The plan sponsor identifies the failures.
- The plan sponsor proposes correction using the General Correction Principles set forth in Rev. Proc. 2006-27, section 6.
- The plan sponsor proposes changes to its administrative procedures to ensure the failures do not recur.
- The plan sponsor pays a compliance fee that generally is based on the number of plan participants as reported on the most recently filed Form 5500 series return according to the following chart:

Number of Plan Participants	Compliance Fee
○ 20 or fewer	○ $ 750
○ 21 to 50	○ $ 1,000
○ 51 to 100	○ $ 2,500
○ 101 to 500	○ $ 5,000
○ 501 to 1,000	○ $ 8,000
○ 1,001 to 5,000	○ $15,000
○ 5,001 to 10,000	○ $20,000
○ Over 10,000	○ $25,000

- The IRS issues a Compliance Statement with respect to the plan detailing the qualification failures identified by the plan sponsor and the applicable correction methods approved by the IRS.
- The plan sponsor corrects the identified failures within 150 days of the issuance of the Compliance Statement.
- While the submission is pending, the plan will not be examined by Employee Plans, except under unusual circumstances.

Audit CAP:

- The plan sponsor or plan is Under Examination.
- The plan sponsor enters into a Closing Agreement with the IRS.
- The plan sponsor effects correction prior to entering into the Closing Agreement.
- The plan sponsor pays a sanction negotiated with the IRS.
- The sanction paid under Audit CAP should be greater than the fee paid under VCP.
- For plans intended to be qualified, the sanction under Audit CAP is a negotiated percentage of the Maximum Payment Amount (MPA) based on the sum for all open taxable years of the:
    1) Tax on the trust (Form 1041) (and any interest and penalties applicable to the trust tax return).
    2) Additional income tax resulting from the loss of employer deductions for plan contributions (and any interest and penalties applicable to the plan sponsor's tax return).
    3) Additional income tax resulting from income inclusion for participants in the plan (Form 1040), including the tax on plan distributions that have been rolled over to other qualified trusts (and any interest and penalties applicable to the participants' tax return).

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1) Has your plan document been updated within the past few years to reflect recent law changes?

Laws related to retirement plans change quite frequently. There are statutory deadlines for which many provisions must become effective. The Service generally establishes a firm deadline for adopting these changes. Also, these law changes might mean you can simplify some areas of plan administration or improve benefits. Plan language and operation will need to be changed to keep the plan within the law and to take advantage of increased benefit limits.

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How to Identify the Mistake:

At some point in the plan's existence, you may be asked to demonstrate your plan has been in compliance with current and prior law. This request may come from a financial institution, third party administrator (TPA), or other plan service provider, or it may come from the IRS during an audit or if you file a determination letter request. You may be asked to demonstrate the plan has been in compliance with all current and prior law, sometimes reaching back several years.

You may have a written plan document that is a pre-approved plan or an individually designed plan. A pre-approved plan is one in which you adopt a plan that has already been reviewed favorably by the IRS. The two main types of pre-approved plans are Master & Prototype plans (M&P) and Volume Submitter plans (VS). M&P sponsors and VS practitioners submit these respective plans in order to obtain an opinion or advisory letter providing the IRS's approval. You may adopt a pre-approved plan from a M&P sponsor or VS practitioner. An individually designed plan document is tailored to meet the particular needs of an employer by providing the maximum amount of flexibility in plan design. It has not been pre-reviewed by the IRS.

You may apply for a determination letter from the IRS to ensure that your retirement plan is written in accordance with the rules of the Code and that necessary amendments to the plan have been adopted when required by law. If your plan is a pre-approved plan, you have a level of assurance that the plan is written in compliance with the law even if you do not apply for a determination letter.

Following is a list of documents you should keep in order to prove the plan has been timely amended:

- Original plan document.
- All subsequent amendments or restatements to the plan document.
- All adoption agreements - An adoption agreement is a document provided by a vendor (e.g., M&P sponsor or VS practitioner) that allows you to choose plan design options. The adoption agreement reflects specific choices made by you for your plan, including eligibility requirements, the types and amounts of contributions allowed, the allocation method for employer contributions, the vesting schedule applicable to employer contributions, and the distribution options. The adoption agreement is not the complete plan document and must be accompanied by a basic plan document, which provides in-depth details of how the plan must operate.
- Any Opinion Letter or Advisory Letter issued by the IRS.
- Any determination letter issued by the IRS.
- Board of Director's resolutions and minutes, or similar records related to the plan.

The Pension Protection Act of 2006 (PPA), signed into law on August 17, 2006, is the most sweeping pension legislation in over 30 years and includes a number of significant tax incentives to enhance and protect retirement savings for millions of Americans. Plan amendments for changes made by PPA will generally not be required to be made until 2009.

A recent law making major changes to 401(k) plans was the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Generally effective for plan years beginning after December 31, 2001, EGTRRA brought a host of changes intended to simplify plan administration while improving benefits. Among the many EGTRRA changes are:

- Catch-up contributions for participants age 50 and over
- Increased contribution limits
- Increased compensation limits
- Higher deduction limits.

Certain provisions of EGTRRA are required to be adopted, while certain provisions are optional. The deadline for amending your plan to reflect a change made by EGTRRA depends on whether the EGTRRA change is mandatory or optional. Generally, the deadline for adopting a mandatory EGTRRA change was on or before the end of the 2002 plan year, since most of the changes become effective in 2002. You may choose to implement an optional, or discretionary, provision of EGTRRA. Any discretionary provision that you implement requires a plan amendment by the end of the plan year in which those provisions were used in the operation of the plan. As long as you adopt your EGTRRA plan amendments within these timeframes and the amendments were a good faith effort to comply with EGTRRA, you have additional time to fix problems with the plan language (if any), apply for a determination letter from the IRS, and make any corrections to your EGTRRA amendments that may be needed. However[1], if you did not adopt an amendment on a timely basis, you are a late amender or a nonamender and your plan is not in compliance with the law and your plan is no longer qualified.[2]

The most recent statutory changes preceding EGTRRA are referred to as GUST. GUST is a grouping of major and minor law changes with varying effective dates depending on the type of plan you have.

The term "GUST" refers to the following Acts:

- Uruguay Round Agreements Act, Pub. L. 103-465 which implemented the Uruguay Round of General Agreement on Tariffs and Trade ("GATT");
- Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353 ("USERRA");
- Small Business Job Protection Act of 1996, Pub. L. 104-188 ("SBJPA");
- Taxpayer Relief Act of 1997, Pub. L. 105-34 ("TRA '97");
- Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206 ("RRA '98"); and
- Community Renewal Tax Relief Act of 2000, Pub. L. 106-554 ("CRA").

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[1] See discussion on Interim Amendments, below.

[2] Under section 1107 of PPA, a plan sponsor is permitted to delay adopting a plan amendment pursuant to statutory provisions under PPA or pursuant to any regulation issued under PPA until the last day of the first plan year beginning on or after January 1, 2009 (January 1, 2011 in the case of governmental plans). This amendment deadline applies to both interim and discretionary amendments that are made pursuant to PPA or any regulation issued under PPA.

GUST provisions generally needed to be adopted by February 28, 2002, for individually designed plans and September 30, 2003, for pre-approved plans. If you did not adopt your plan's GUST provisions by the applicable due date, then you are a late/nonamender and your plan is not in compliance with the law and your plan is no longer qualified.

In addition to statutory and regulatory changes, the IRS continues to provide guidance on qualification requirements, which must be accounted for in keeping plans up to date.

The IRS publishes annually a Cumulative List of Changes in Plan Qualification Requirements toward the end of each year. The Cumulative List will help you understand what amendments have to be finalized in your plan by the end of your current 5-year Cycle (discussed below). The most current Cumulative List is Notice 2007-3. The Cumulative List in Notice 2007-3 is for Cycle B plan sponsors to use in drafting their plans for the submission period ending on January 31, 2008.

In February of 2005, IRS changed its determination letter program and the rules for when a plan has to be amended for changes in the law.

New Submission Procedures for Individually Designed Plans - 5-Year Remedial Amendment Cycle

If you maintain an individually designed plan and you want continuing assurance that your plan document meets the requirements of the law, you will now need to submit applications for determination letters only once every five years, under a staggered system of 5-year remedial amendment cycles (Cycles A - E). Generally, the cycle that applies to your plan depends on the last digit of your Employer Identification Number (EIN). Your submission period occurs in the last 12 months of your remedial amendment cycle.

For example, the first 5-year period for plans falling into Cycle B ends on January 31, 2008, and the initial submission period also ends on that date. If you fall under Cycle B based on a last digit EIN of 2 or 7, you would submit your determination letter application between February 1, 2007 and January 31, 2008. A chart is available for reference so you can determine your cycle.

Under this system, when you file your determination letter application, you will have the opportunity to make any necessary corrections to good faith, interim and discretionary amendments you adopted during the 5-year cycle, provided you adopted these interim and discretionary amendments on time and in good faith.

Interim amendments are required to keep a written plan document up to date between a plan's submission periods during the applicable remedial amendment cycles. Other amendments are discretionary amendments. The general deadline for timely adoption of an interim or discretionary amendment can be found in section 5.05 of Rev. Proc. 2007-44. An interim amendment must usually be adopted by the later of the due date (including extensions) for filing the income tax return for the employer's taxable year that includes the date on which the amendment is effective or the last day of the plan year that includes the date on which the amendment is effective. A discretionary amendment must be adopted by the end of the plan year in which the plan amendment is effective. For a calendar year plan, this would be December 31 of the year in which the amendment becomes effective.

Interim amendments include one or more of the following:

- The good faith EGTRRA amendments described in Notices 2001-42 and 2005-5;
- Amendments required for compliance with the final and temporary regulations under section 401(a) (9), relating to minimum distributions, as described in Rev. Proc. 2002-29 (as modified by Rev. Proc. 2003-10); and
- Interim amendments described in section 5 of Rev. Proc. 2007-44.

An interim amendment does not include any amendment adopted to correct a mistake to operate the plan in accordance with the plan's terms. For example, if a plan provides for a 6-year graded vesting schedule and the plan operated on a 5-year graded vesting schedule, a corrective amendment providing for a 5-year graded vesting schedule is not an interim amendment.

In addition, an interim amendment does not include any amendment adopted to comply with legislation for which the remedial amendment period has already expired. Thus, an amendment adopted to bring a plan into compliance with GUST or any other previous legislation is not a good faith or interim amendment.

New Submission Procedures for Pre-Approved Plans
The IRS has also changed its procedures regarding pre-approved plans so that M&P sponsors and VS practitioners will restate and submit the plans to the IRS for pre-approval only once every six years. Likewise, if you have adopted a pre-approved plan, you will need to adopt the restated plan only once every six years, and if you want continued assurance on a determination letter, you will need to apply for a new letter only at that time. The IRS will notify the M&P sponsor or VS practitioner when you must adopt the restated plan.

We recommend you contact the person who sold you the plan to discuss the status of your plan document.

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How to Correct the Mistake:

Corrective Action:
If you find your plan hasn't been amended timely for the various law changes you should take the following steps:

- Adopt amendment(s) for the law changes you have missed. You may be able to utilize model or sample amendments published by the IRS which apply to your 401(k) plan. You will need to confirm that the operation of the plan is consistent with the terms of the plan.
- The following items of guidance released by the IRS contain model or sample plan amendments:
  - Sample plan amendments for complying with EGTRRA (See Notice 2001-57)
  - Model plan amendments for complying with final and temporary regulations under Code section 401(a)(9) (See Rev. Proc. 2002-29).
- Also, you may adopt a pre-approved plan from a M&P sponsor or VS practitioner. In this case, the process for entering into the VCP is a quicker process since the scope of review for the IRS is limited. The IRS has already reviewed the provisions in the pre-approved plan adopted by the employer, as opposed to an individually designed plan, where the Service would have to review the entire plan document.

- The effective date of the amendment should be retroactive to conform the terms of the plan to the requirements of the applicable legislation.
- File a VCP submission with the IRS using Rev. Proc. 2006-27.

If the only mistake in the VCP submission involves the late adoption of good faith (see EGTRRA explanation above) or interim amendments (see explanation above), then, Appendix F of Rev. Proc. 2006-27, a simplified filing procedure, can be utilized by the plan sponsor. Appendix F specifies the information that needs to be submitted for a complete application. If the information is satisfactory, the IRS will sign the compliance statement and return it to the plan sponsor and/or authorized representative. The compliance statement does not express an opinion on the content of the amendments, but it signifies the IRS's agreement to treat the interim amendments as if they were adopted timely for the purpose of making the remedial amendment period available to the plan. Please refer to the EPCRS overview above for an extended discussion of the VCP program.

If the nonamender mistake involves GUST or prior legislation, these are not considered interim amendments and the plan sponsor would not be eligible for Appendix F. You may utilize a sample VCP submission format provided in Appendix D of Rev. Proc. 2006-27.

Example:
Plan Sponsor X for Plan ABC, a calendar year 401(k) plan (with 40 participants), discovers it has missed the deadline for adopting good-faith EGTRRA amendments (December 31, 2002). X already has a favorable determination letter for GUST.

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Correction Program(s) Available:

SCP:
This type of mistake may not be corrected under SCP. As stated above, SCP is limited to operational problems, and this mistake is the result of the failure to keep the plan language up to date. In order to retain plan qualification, this mistake must be corrected under VCP.

VCP:
The plan sponsor makes a VCP submission to the Service pursuant to Rev. Proc. 2006-27 identifying the failure.

The fee for this size plan would normally be $1,000; however, if the failure to make timely good faith amendments is the only mistake in the submission, the rev. proc. provides for a reduced fee of $375 regardless of the number of participants in the plan. (See section 12.03 of Rev. Proc. 2006-27.) Plan Sponsor X may use the streamlined application procedure for good faith nonamenders in Appendix F of Rev. Proc. 2006-27.

Example:
Same facts as prior example, except that plan sponsor X does not timely amend its plan for changes in the law mandated by EGTRRA. X's plan should have been amended by the end of Cycle A to have been considered to have been amended timely.

The fee in this case is generally $1,000; however, if X's only mistake was being a late amender for Cycle A (due date/end of remedial amendment cycle was January 31, 2007) and X files a VCP submission within one year of the end of Cycle A (by January

31, 2008), then X’s fee would be reduced by 50% of the normal fee provided for in the fee chart (($1,000 x 50% = $500) See Sec. 12.03 of Rev. Proc. 2006-27.)

Audit CAP:

If this mistake is discovered on audit, it may be corrected under Audit CAP. Correction of the plan under Audit CAP should be very similar to correction under SCP. The sanction under Audit CAP is a percentage of the Maximum Payment Amount (MPA).
In addition, a nonamender mistake discovered by the revenue agent during the determination letter process is subject to a higher fee than if the mistake is brought to the attention of the agent in the application. If you have filed for a determination letter and discover you may be a nonamender, bring this to the attention of the agent immediately in order to avoid the higher fee under Sec. 14.04 of Rev. Proc. 2006-27.

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How to Avoid the Mistake:

There are a number of ways to avoid this mistake:

- Plan sponsors need to resort to a calendar (tickler file) of when amendments must be completed.
- Do an annual review of your plan document.
- Make sure your plan document and Summary Plan Description (SPD) match. If your plan document is amended, check the language against the old plan document, noting any differences.
- Knowing your plan has been properly updated may not be a simple process. Certain plans must be individually amended for each change, while others may have a prototype document that is amended. We recommend you maintain contact, on at least a yearly basis, with the company that sold you the plan. If the company sends you a set of amendments to formally adopt, make certain you timely execute the documents per their instructions. Keep signed and dated copies of your plan document and any amendments for your records.

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2) Are the plan’s operations based on the terms of the plan document?

The plan sponsor/employer is ultimately responsible for keeping the plan in compliance with applicable tax laws; however, there may be many different employees, vendors, and tax professionals who service your plan. This retirement team may include numerous people in a large plan or as few as one in a small plan.

Any changes made to your plan document or to the operation of your plan should be conveyed to everyone providing service to your plan. For example, assume your plan document is amended to change the definition of compensation. That change should then be communicated to all persons involved in determining deferral amounts to be withheld from the participant’s pay, performing your plan’s nondiscrimination tests, or allocating employer contributions. Communication among the people who service your plan is essential for a compliant plan. Also, if you decide to implement a different definition of compensation in operation, make sure the plan is amended timely to reflect that change. Below are some common changes where due diligence is needed to identify any potential mistakes.

- If you made any changes to your plan document, all persons who service your plan should be informed of those changes and what they mean to the operation of your plan.
- If you amend your plan document, you should also amend your summary plan description (SPD). If a plan is materially modified, a summary of the material modifications (SMM) must be given to the plan participants within 210 days after the end of the plan year in which the modification was adopted.
- If you've changed the way you operate your plan, those changes should also be communicated to the persons providing service to your plan. You may need to reflect these changes in your plan document through a plan amendment.
- If you've changed the trustees for your plan, those changes also need to be conveyed and your plan document and SPD may need to be updated.
- Any changes in the ownership interests may affect the nondiscrimination testing for the plan and should be conveyed to your plan service providers. An acquisition of a company should be shared with your plan service providers.

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How to Identify the Mistake:

You must be familiar with the plan document to be able to find whether or not the plan has been operated in accordance with its terms. Following the terms of the plan document is crucial to ensure tax-favored treatment of the plan. Be familiar with the wording in the plan document and how it affects the operation of the plan. Conduct an independent review of your plan and its operation on an annual basis. If you operate your plan using a summary, check the requirements and definitions on that sheet to make certain they correspond to the plan document. Consider conducting a 401(k) plan check-up using the 401(k) plan checklist.

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How to Correct the Mistake:

Corrective Action:
If you find an error in the operation of your plan, you should correct the error as soon as feasible. Use a reasonable correction method that would place affected participants in the position they would have been in had there been no operational plan defects. Section 6 of Rev. Proc. 2006-27 provides general correction principles that should be used in determining an appropriate method of correction. The examples in Appendices A & B of Rev. Proc. 2006-27 are deemed to be reasonable and appropriate correction methods.

Example:
Employer A's 401(k) plan provides for employer matching contributions of 50% of the deferrals made to the plan, up to the first 6% of compensation. These employer matching contributions are vested at the rate of 20% per year. There are 75 participants in the plan. A participant must work at least 1,000 hours in a calendar year to receive vesting credit for that year. Participant X participated in the plan from January 1, 2003, to September 30, 2006, when he terminated employment. Participant X worked 2,000 hours in 2003, 2004, and 2005, and during 2006, the year of termination, Participant X worked 1,100 hours. At termination, his plan benefits were paid to him in a lump sum. His account balance due to employer matching contributions was $5,000 at that time. Employer A calculated X's vested percentage as 60%, 20% for each of the 3 full

calendar years he was employed. Participant X was paid $3,000 from his employer matching contribution account.

A mistake has occurred because Participant X should have been credited with a vesting year of service for the final year of employment, 2006, since he had worked in excess of 1,000 hours in that plan year. Participant X should have been vested at 80% for the 4 years of vesting service.

Reasonable Correction:
Employer A needs to make a corrective distribution to Participant X in order to correct the vesting mistake. Participant X should be credited with an additional 20% of the account balance of $5,000, or $1,000, plus any additional earnings from the date of the original distribution to the date of the corrective distribution.

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Correction Program(s) Available:

SCP:
The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly applying the vesting provisions to Participant X. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer A may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Corrective distribution needs to be made by December 31, 2008.
  - If not corrected by December 31, 2008, Employer A is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2008, SCP may only be used provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer A can make a corrective distribution beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer A makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $2,500 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer A and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:
Be sure that the provisions of the plan are applied correctly when making a determination of what contributions or benefits will be provided to participants. Plan

sponsors need to develop a communication mechanism to make all relevant parties aware of changes on a timely and accurate basis (best practices).

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3) Is the plan's definition of compensation for all deferrals and allocations used correctly?

Because your plan may use different definitions of compensation for different purposes, it's important that you apply the proper definition when dealing with deferrals and allocations. A plan's definition of compensation must satisfy applicable rules for the purpose of determining the amount of contributions. The amount of compensation taken into account under the plan cannot exceed $225,000 in 2007, and is subject to cost-of-living adjustments for later years. This limit is described in Section 401(a) (17) of the Code.

The definition of compensation stated in the plan document must be followed in the operation of the plan. Compensation generally includes the pay a participant received from the employer for personal services for a year including:

- Wages and salaries.
- Fees for professional services.
- Other amounts received (cash or non-cash) for personal services actually rendered by an employee, including, but not limited to, the following items:
  - Commissions and tips.
  - Fringe benefits.
  - Bonuses.

You may not be aware your plan contains different definitions of compensation for different plan purposes. In some cases, you or the plan administrator may use the incorrect definition of compensation when determining the compensation eligible to be deferred, computing the matching contribution, and when calculating the ADP or ACP test. Also, you or the plan administrator may fail to limit compensation as required under Code section 401(a) (17).

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<u>How to Identify the Mistake</u>:

To determine if your plan is using the proper compensation for allocations and deferrals as required by the plan, you'll need to review the plan document. Many plans are operated based on a short summary of the plan containing many of the definitions and operational requirements. But as the plan is amended, the compensation definition may change while the plan continues to operate as it had previously.

Review the plan section that deals with allocations and deferrals. Each plan document contains a section, either in the plan document or in an attached adoption agreement that discusses how allocations and/or deferrals must be made. This plan or adoption agreement section will have language that says, for example, "Employees may defer up to 15% of their Compensation…" You then have to go to the plan section containing definitions and find the "Compensation" definition. Spot check deferrals and allocations to see if the correct compensation is being used. Some of these definitions can get very complicated with expense reimbursements, car allowances, bonuses, commissions, and overtime pay that is included or not included in the definition of compensation. If you have a plan with a complicated definition of compensation, develop a worksheet to calculate the correct amounts.

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How to Correct the Mistake:

Corrective Action:

There are a couple of ways to make corrections when amounts are improperly allocated based upon compensation. If you have improperly determined elective deferrals, a distribution of the excess amount plus earnings should be made to the participant. If there are improper profit-sharing allocations, the allocations plus earnings should be forfeited and reallocated to plan participants at a later date or placed in an unallocated account for later use. Of course, an improper allocation may also result in an under contribution. If this occurs, a corrective contribution, including earnings, would be made on behalf of the affected participants.

Example:

Employer Z sponsors a 401(k) plan for its employees. There are 16 participants in the plan. The plan's definition of compensation for deferrals and allocations was amended, effective 2004, to exclude bonuses. For the 2006 plan year, bonuses were not excluded from compensation before determining allocations and deferrals. There are three highly compensated employees (HCEs) who each had base compensation of $120,000 and received a $30,000 bonus. Each of these HCEs had deferral percentages of 6% of compensation and the plan provides for a fixed profit-sharing allocation of 5% of compensation to each participant's account.

- Each of the three HCEs properly received a profit-sharing allocation equal to 5% of their $120,000 compensation ($6,000) but improperly received an allocation equal to 5% of the $30,000 bonus ($1,500).
- Each of the three HCEs properly deferred 6% of their $120,000 base compensation ($7,200), but improperly deferred 6% of the $30,000 bonus ($1,800).

Correction:

For each HCE, forfeit the profit-sharing allocations of $1,500 plus earnings and place such allocations in an unallocated account to be used for profit-sharing allocations in future plan years. Distribute the improperly allocated elective deferrals of $1,800 plus earnings to each of the three HCEs.

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Correction Program(s) Available:

SCP:

The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to exclude bonuses from compensation used to determine allocations under the plan. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer Z may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Correction needs to be completed by December 31, 2008.

- If not corrected by December 31, 2008, Employer Z is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2008, SCP may only be used provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer Z can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer Z makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $750 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer Z and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

There are a number of ways to avoid this mistake:
- Perform annual reviews of your plan's operations.
- If your plan document is amended, check the definitions against the old plan document, noting any differences.
- If your plan document is amended, communicate those changes to everyone involved in the plan's operations.
- Make sure the person in charge of determining compensation is properly trained to understand the plan document.
- Know what your third-party administrators have agreed to provide for you. They may be relying on you for all information, such as compensation and deferral amounts, used in their own work.
- If possible, simplify your plan's definition of compensation and use the same definition for multiple purposes.

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4) Were employer matching contributions made to all appropriate employees under the terms of the plan?

Employers sometimes fail to contribute the employer matching contribution provided for under the terms of the plan document. In many cases, the problem is caused by your and/or the plan administrator's mistake to properly count hours of service or identify plan entry dates for employees. Incorrect contributions are also made when you and/or the plan service providers fail to follow the terms of the plan document. Another common problem is using the incorrect definition of compensation described in the plan document for the purpose of determining matching contributions. For example, you or your administrator may not include deferrals in compensation as required under the plan document when calculating the matching contribution.

Another problem has to do with the timing of matching contributions. The terms of a plan usually state that employer matching contributions will be a percentage of participant deferrals, up to a specified level. Plans generally describe these matching contributions in terms of annual amounts and percentages. If your plan administrator calculates the matching contribution on a payroll period basis, rather than on an annual basis, at the end of the year the sum of these amounts may not comply with the terms of the plan.

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How to Identify the Mistake:

To avoid mistakes in this area, the plan document should be reviewed as it relates to matching contributions.

- Review the plan document to determine the correct matching contribution formula and compare it to what is used in operation.
- Review the definition of compensation used to calculate matching contributions
  - Incorrect compensation used to determine elective deferrals normally leads to mistakes in the match.
- Review the timing of the matching contribution in comparison to the plan document requirements.
  - If the plan document states the match is a percentage of the deferrals made on a yearly basis and matches are made on a weekly basis, you may have a mistake.
- Be aware of any changes to your plan document.

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How to Correct the Mistake:

Corrective Action:
Correction of an incorrect employer matching contribution should be based upon the terms of the plan and other applicable information at the time of the mistake (See Sec. 6.02 of Rev. Proc. 2006-27).

Example:
Employer D sponsors a 401(k) plan with a calendar-year plan year. The plan document provides that the employer will make matching contributions based upon an employee's elective deferrals for the year. It further provides that the match will equal 50% of the amount deferred by the participant for the year up to 6% of compensation. Therefore, a participant deferring at least 6% of compensation should have a matching contribution allocation of 3% of compensation. Participants are allowed to change their deferral levels at stated intervals during the year.

During the 2006 plan year, the plan sponsor erroneously computed its match based on 50% of the amount deferred by Participant A for the year up to 3% of compensation instead of 6% of compensation. Participant A received $50,000 in compensation and elected an 8% rate of deferral ($50,000 x 8% = $4,000 elective deferrals). Employer D provided a matching contribution to Participant A totaling $750 ($50,000 x 3% x 50% limitation). Under the terms of the plan, Participant A was entitled to a $1,500 match ($50,000 x 6% x 50% limitation). As a result, Employer D needs to make a corrective contribution of $750 plus earnings on behalf of Participant A to correct the operational mistake. The plan has 20 participants.

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Correction Program(s) Available:

SCP:
The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by improperly applying the matching contribution formula under the plan. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer A may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - Corrective contribution needs to be made by December 31, 2008.
    - If not corrected by December 31, 2008, Employer D is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2008, SCP may only be used provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer D makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $750 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

You need to be familiar with the terms of your plan and implement procedures to ensure that your plan operates in accordance with your plan document. You should work with your plan administrators to ensure that they have sufficient employment and payroll information to calculate the employer matching contribution described under the terms of the plan document.

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5) Has your plan satisfied the nondiscrimination tests (ADP and ACP)?

What are the ADP and ACP tests? Traditional 401(k) plans must be tested annually to assure that the amount of contributions made by and on behalf of rank-and-file employees, (nonhighly compensated employees (NHCEs)), are proportional to contributions made on behalf of owners and managers, (highly compensated employees (HCEs)). As the NHCEs save more for retirement, the HCEs are allowed to defer more. These nondiscrimination tests for 401(k) plans are known as the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests.

The ADP test applies to elective deferrals (including both before-tax deferrals and Roth deferrals) of the HCEs and NHCEs. Dividing the elective deferrals by the compensation for an individual participant will give you that participant's Actual Deferral Ratio (ADR). Add up the ADR for each individual participant who is a NHCE (even if they chose not to make an elective deferral) and divide by the total number of NHCEs and you'll have the ADP for the NHCE group. Do the same for the HCEs to determine their ADP. ACP is calculated in the same manner, instead using the matching contributions and employee contributions (not including deferrals) for each participant, divided by the compensation.

The ADP test is met if the ADP for the eligible HCEs does not exceed the greater of:

- 125% of the ADP for the group of NHCEs, or
- the lesser of:
    - 200% of the ADP for the group of NHCEs, or
    - The ADP of for the group of NHCEs plus 2%.

The ACP test is met if the ACP for the eligible HCEs does not exceed the greater of:

- 125% of the ACP for the group of NHCEs, or
- the lesser of:
    - 200% of the ACP for the group of NHCEs, or
    - The ACP of for the group of NHCEs plus 2%.

Both the ADP and ACP percentages for NHCEs may be based on either the current year contributions or the contributions of the prior year. The election to use current or prior year data is contained in the plan document. Under limited circumstances, the election may be changed.

An important aspect of performing the ADP and ACP tests is to properly identify the HCEs. HCEs are defined under Code section 414(q) and generally include any employee who:

- Was a 5-percent owner at any time during the year or preceding year (a 5% owner is someone who owns more than 5% of the employer), or
- For the preceding year had compensation from the employer in excess of $100,000 (for 2007 and subject to cost-of-living adjustments in later years) and, if the employer elects, was a member of the top-paid group (top 20%) of employees.

Remember, when you're determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. Any individual who is a spouse, child, grandparent, or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, is treated as a 5% owner. As a 5% owner, each of these individuals would also be considered HCEs for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to the TPA, advisor, or persons performing the appropriate nondiscrimination tests.

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How to Identify the Mistake:

An independent review should be completed to determine if HCEs and NHCEs were properly classified for purposes of the ADP and ACP nondiscrimination tests. Plan administrators should pay special attention to:

- Prior year compensation.
- The attribution rules related to ownership when identifying 5% owners.
    - TPAs need access to ownership documents to identify 5% owners.
    - Take care to identify family members of the owners, as many will have different last names, which may warrant further review for proper attribution.

Also, review the rules and definitions in your plan document for:

- Properly determining HCEs
- Compensation
- ADP testing
- ACP testing
- Prior or current year testing.

For each employee, determine if they have been properly identified as HCEs or NHCEs. An HCE or NHCE includes all employees eligible to make an elective deferral, even if they choose not to make one for the plan year.

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How to Correct the Mistake:

Corrective Action:
If a plan fails to satisfy the ADP and/or ACP test and the mistake is not timely corrected, it may result in plan disqualification. If the data used for the original testing is incorrect, then the ADP and/or ACP tests may have to be rerun. If the original or corrected test fails, then corrective action is required in order to rectify the excess contributions that were made to the HCEs.

- By regulations, corrective action described in the plan document must be taken within 12 months following the end of the plan year to which the excess contributions (ADP) or excess aggregate contributions (ACP) relate. If this is done, EPCRS is not needed.
- If 12 months have elapsed since the close of the plan year, you may pursue corrective action through EPCRS.

There are two different methods of correcting ADP and ACP testing mistakes. You may choose whichever method you prefer. Both require a contribution to the plan on behalf of NHCEs.

- Method 1 - Under EPCRS, Appendix A, section .03 of Rev. Proc. 2006-27, the permitted correction method is to:
    - Determine the amount necessary to raise the ADP or ACP of the NHCEs to the percentage needed to pass the tests.
    - Make qualified nonelective contributions (QNECs) on behalf of the NHCEs to the extent necessary to pass the tests. A QNEC is an employer contribution that is always 100% vested.
        - QNECs must be made on behalf of all eligible NHCEs (as long as the contribution does not cause the 415 limit to be exceeded). The 415 limit refers to a limit on annual additions that may be credited

        - to a participant's account in a given year. Annual additions consist of employer contributions, forfeitures, and employee contributions.
        - These contributions must be the same percentage for each participant.
- Method 2 - Under EPCRS, Appendix B, section 2.01, an alternative permitted correction method is referred to as the one-to-one method.
    - Excess contribution amounts (adjusted for earnings) are assigned and distributed to the HCEs.
    - Any forfeited amounts due to matching contributions are to be used in accordance with the plan document provisions relating to forfeiture.
    - That same dollar amount (i.e., the excess contribution amount, adjusted for earnings) is contributed (in the form of a QNEC) to the plan and allocated prorata, based on compensation, to all eligible NHCEs.

<u>Example:</u>
Employer XXG, Inc. maintains a profit-sharing plan with a 401(k) feature for its employees. During 2007, the employer performed a review of the plan's operations for the 2005 plan year. During this review, it was discovered one participant identified as an NHCE was the child of a 5% owner. When the ADP test was rerun with the corrected classification, HCEs had an ADP of 7% and NHCEs had an ADP of 4%. The maximum passing ADP for the HCE group is 6%; therefore, the plan failed the ADP test. There were no matching or other employee contributions for the 2005 plan year. The plan has 21 participants.

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<u>Correction Program(s) Available:</u>

<u>SCP:</u>
This error is considered to be an operational error under EPCRS. Plan Sponsor XXG corrected this mistake under SCP in 2007. XXG determined that the plan had established practices and procedures designed to keep the plan compliant and that the mistake was not significant. Correction could involve one of two methods:

- The plan sponsor could make QNECs to the NHCEs in the amount necessary to raise the ADP to a percentage that would enable the plan to pass the test.
    - In this example, each NHCE would receive a QNEC equal to 1% of the employee's compensation.
    - These contributions must be made on behalf of each eligible NHCE (as long as the contribution does not cause the section 415 limit to be exceeded).
- Under the second method, the plan could use the one-to-one correction method.
    - Excess contribution amounts are determined.
    - The amount is assigned to HCEs and adjusted for earnings.
        - This total amount is distributed to the HCEs.
    - An amount equal to the distributed amount is contributed to the plan and allocated prorata, based on compensation, among the eligible NHCEs.

If XXG determined the mistake to be significant, the correction must be made by the end of the correction period. The correction period, as it pertains to an ADP/ACP testing failure, ends on the last day of the second plan year following the plan year that includes the last day that correction of the ADP/ACP mistake could occur under the regulations. The mistake occurred in 2005, with the regulatory correction period ending in 2006, so the correction period under SCP ends on the last day of the 2008 plan year for significant mistakes.

VCP:
If XXG determined the mistake was not correctible under SCP, or if it elected to correct the mistake under VCP, correction would be the same as under SCP. XXG would need to file a VCP application. Based on the number of participants in our example, 21, XXG would pay a fee of $1,000.

Audit CAP:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction will bear a reasonable relationship to the nature, extent, and severity of the mistake, taking into account many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

One way to avoid this type of mistake may is by establishing a safe harbor 401(k) plan or changing an existing plan from a traditional 401(k) plan to a safe harbor 401(k) plan. Under a safe harbor 401(k) plan, the employer is not required to perform the ADP and ACP tests, if certain requirements are met.

Problems typically result when there is a communication gap between the employer and plan administrator with respect to what the plan document provides and what documentation is needed to ensure compliance. There are several main areas where these communications problems may occur:

- Counting all eligible employees in testing:
    - Information must be shared with the TPA on all employees eligible to make an elective deferral.
    - This would include an eligible employee who terminated voluntarily or involuntarily during the year.
- Information regarding any related companies with common ownership interests should be shared with the TPA.
    - Your plan may require these employees to be eligible to participate in the plan, and therefore included in the various tests.
- Definition of compensation:
    - Be familiar with the terms of the plan document to ensure the proper definition of compensation is used.
    - It's important to know whether compensation is:
        - Excluded for certain purposes,
        - Limited for certain purposes, or
        - Determined using a different computation period (e.g., plan year vs. calendar year).
    - If the compensation amounts forwarded to the TPA do not meet the plan definitions, the ADP and ACP tests will be inaccurate and provide false results.
- Identification of HCEs - An important aspect of performing the ADP and ACP tests is properly identifying HCEs.

In summary, you should ensure that you are familiar with the terms of the plan, and your TPA (if you have one) is provided with all of the information needed to make a proper determination of each employee's status.

If either the ADP or ACP test fails, then in order to avoid having to correct under EPCRS or face this issue on audit, procedures should be implemented to ensure that excess contributions and/or excess aggregate contributions are corrected in a timely manner. Excess contributions result from plans that fail to satisfy the ADP test. They are the amounts that should be distributed to the applicable highly compensated employees within 12 months following the close of the plan year. Excess aggregate contributions are contributions resulting from a plan that has failed the ACP test. They are generally treated in the same manner as excess contributions. However, if the excess aggregate contributions consist of matching contributions that are not fully vested, then the unvested portion is reallocated to the accounts of the other plan participants or placed in an unallocated suspense account to be used to reduce future contributions.

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6) Were all eligible employees identified and given the opportunity to make an elective deferral election? (exclusion of eligible employees)?

Your plan document should contain a specific definition of *employee* and provide requirements for when employees become plan participants eligible to make elective deferrals into your 401(k) plan. Employers sometimes assume certain employees, such as part-time employees, are not covered by the plan. Similarly, employees who elect not to make elective deferrals are often mistakenly treated as employees ineligible under the plan when contributions to the plan are made and tests are run. To reduce the risk of omitting eligible employees, you should ensure that employee data such as dates of birth, dates of hire, dates of termination, number of hours worked, compensation for the plan year, 401(k) election information, and any other information necessary to properly administer the plan, are accurate.

Generally, under a 401(k) plan, each employee who receives a Form W-2 should be treated as an eligible employee unless he or she can be properly excluded by the plan's terms. Using the plan's definition of eligible employee along with the plan's age and service requirements, a determination of eligibility should be made for each employee receiving a Form W-2. That can be a fairly simple process; however, if you use leased employees, contract labor, or have shared ownership of other enterprises, determining eligible employees can become more complicated.

A retirement plan does not qualify for tax-preferential treatment unless certain standards are met. The eligibility and participation standards must be met in order for a plan to maintain tax-favored treatment. These general rules are:

- A plan may not require an employee to be older than 21 in order to participate in a plan, and
- There are two ways to credit service to an employee, which are:
  - hours of service measured in the context of a year of service (this is the more common method) and
  - periods of employment, commonly referred to as the elapsed time method.

- **Hours of service:** A 401(k) plan may not require more than a year of service as a condition of becoming a participant in a plan.
  - A year of service means a calendar year, a plan year, or any other consecutive 12-month period during which the employee completes at

    least 1,000 hours of service starting on the employment commencement date.
  - An eligible employee meeting these requirements must enter the plan at the beginning of the next plan year, or 6 months after satisfying any eligibility requirements under the plan, if earlier.
  - More liberal rules may be imposed in the plan document by allowing a younger age and lesser service requirement.
    - For example, a plan may allow a person to participate immediately upon becoming an employee.
- **Elapsed time method:** Under the elapsed time method, an employee's eligibility to participate is not based upon the completion of a specified number of hours of service during a 12-consecutive-month period. Instead, it is determined generally with reference to the total period of time which elapses while the employee is employed.
- Your plan document contains the definitions and requirements for becoming a participant in the plan.

In addition to identifying eligible employees, you must also give them the opportunity to make a salary deferral election. You should have procedures in place to notify these employees of their eligibility and how and when they may participate.

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How to Identify the Mistake:

Review your plan document concerning the section on eligibility and participation. Check when employees are entering the plan. Treat each employee who received a W-2 during the year as an eligible employee.

- Make a list of all employees who received a W-2.
- Compare their dates of hire, dates of birth, dates of termination, and number of hours worked against the eligibility and participation requirements of the plan document.
- Determine the date that each employee is entitled to become a participant in the plan (plan entry date) according to the plan document.
- Inspect payroll and plan records to make certain the employees timely entered the plan and were given the opportunity to make a salary deferral election.

Return to Table

How to Correct the Mistake:

Corrective Action:
Generally, if an employee was not provided the opportunity to make elective deferrals to a 401(k) plan, you must make a qualified nonelective contribution (QNEC) to the plan on behalf of the employee that compensates for the missed deferral opportunity. The corrective QNEC is an employer contribution that is intended to replace the lost opportunity to a participant as a result of not being permitted to make elective deferrals.

The amount of the QNEC is equal to **50%** of the employee's missed deferral. The missed deferral is determined by multiplying the actual deferral percentage (ADP) for the employee's group (HCE or NHCE) in the plan for the year of exclusion by the employee's compensation for that year.

Example:
Employer D sponsors a 401(k) plan with 8 participants. The plan uses the calendar year as its plan year. The plan has a one year of service eligibility requirement and provides for January 1 and July 1 entry dates. Employee Y, who should have been provided the opportunity to make elective deferrals on January 1, 2003, was not provided the opportunity until January 1, 2004. Employee Y was a NHCE with compensation for 2003 of $80,000. The ADP for HCEs for 2003 was 10%. The ADP for NHCEs for 2003 was 8%. Employer D discovers this mistake during a review of the plan in 2006.

How to Correct the Mistake:

Corrective Action:
Employer D must make a corrective contribution for the 2003 missed deferral opportunity. Employee Y's missed deferral is equal to the 8% ADP for NHCEs multiplied by $80,000 (compensation earned for the portion of the year in which Employee Y was erroneously excluded, January 1 through December 31, 2003). The missed deferral amount, based on this calculation is $6,400 ($80,000 x 8%). The missed deferral opportunity is $3,200 (50% multiplied by the missed deferral of $6,400). Accordingly, Employer D is required to make a corrective contribution of $3,200 on behalf of Employee Y. This corrective contribution of $3,200 is adjusted for earnings through the date of correction.

Return to Table

Correction Program(s) Available:

SCP:
The example illustrates an operational problem, in that the employer failed to follow the terms of the plan by failing to give Employee Y the opportunity to participant in the plan for the 2003 plan year. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer D may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - A corrective contribution needs to be made by December 31, 2005.
  - If not corrected by December 31, 2005, Employer D is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2005, SCP may only be used provided the other requirements of SCP are satisfied.

If the mistakes are **insignificant** in the aggregate, Employer D can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer D makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $750 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer D and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

Review your plan document and inspect your payroll records to extract the total number of employees, birth dates, hire dates, hours worked and other pertinent information. Also inspect form(s) W-2 and State Unemployment Tax returns (compare the employees on these records with the payroll records) to see if employee counts are accurate.

Return to Table

7) Are elective deferrals limited to the amounts under IRC section 402(g) for the calendar year and have any excess deferrals been distributed?

Code section 402(g) places a limit on the amount of elective deferrals a plan participant may exclude from taxable income each calendar year. IRC section 401(a)(30) provides that in order for a plan to be qualified, it must provide that the amount of elective deferrals for each participant under all plans of the same employer not exceed the limitation on elective deferrals provided in IRC section 402(g). The limits on elective deferrals under IRC 402(g) are:

- 2005 - $14,000
- 2006 - $15,000
- 2007 - $15,500
- This limit is subject to cost-of-living increases after 2007. (For 2004 and prior years, please refer to the Cost-of–living adjustment (COLA) table.)

Limits on the amount of elective deferrals a plan participant may contribute to a SIMPLE 401(k) plan are different from those in a traditional or safe harbor 401(k) plan.

- SIMPLE 401(k) deferrals are limited to $10,000 for 2006, $10,500 for 2007.
- This limit is subject to cost-of-living increases after 2007.

Catch-up contributions: For tax years beginning after 2001, a plan may permit participants who are age 50 or over at the end of the calendar year to make additional elective deferrals. These additional contributions (commonly referred to as catch-up contributions) are not subject to the general limits that apply to 401(k) plans. An employer is not required to provide for catch-up contributions in any of its plans. However, if your plan does allow catch-up contributions, it must allow **all** eligible participants to make the same election with respect to catch-up contributions.

- If an employee participates in a traditional or safe harbor 401(k) plan and is age 50 or older:
  - The elective deferral limit increases by $5,000 for 2006 and 2007.
  - The limit is subject to cost-of-living increases after 2007.

- If an employee participates in a SIMPLE 401(k) plan and is age 50 or older:
  - The elective deferral limit increases by $2,500 for 2006 and 2007.
  - The limit is subject to cost-of-living increases after 2007.

- The catch-up contribution for a year cannot exceed the lesser of the following amounts:
  - The catch-up contribution limit above, or

- The excess of your compensation over the elective deferrals that are not catch-up contributions.

Catch-up contributions are **not** subject to the 401(a)(30) plan qualification rule referred to above. The maximum limits for catch-up contributions are found in section 414(v) of the Code.

Elective deferrals include both pre-tax elective deferrals and designated Roth contributions. Generally, all elective deferrals made by a participant to all plans in which the employee participates must be considered to determine if the section 402(g) limits are exceeded. If an employee has elective deferrals in excess of the 402(g) limit under one or more plans of an employer, each plan is disqualified.

General rules for 401(k) plans provide for the dollar limits described above; however, the amount a plan participant is entitled to defer is also subject to other limits as described in your plan document. For example, your plan document may place its own, lower limit on the amount of the deferral or on the percentage of pay that may be deferred. Additionally, your plan may need to further limit a plan participant's elective deferrals in order to meet certain nondiscrimination requirements.

If the total of a plan participant's elective deferrals is more than the limit under Code section 402(g), to avoid failing Code section 401(a)(30), the excess amount plus allocable earnings must be distributed to the participant by April 15 of the year following the year in which the excess occurred. Excess deferrals not timely returned to the participant are subject to additional taxation. Following is a discussion of the tax consequences of excess deferrals.

Timely Withdrawal of Excess Contributions by April 15.

- Excess deferrals withdrawn by April 15 of the year following the year of deferral are taxable in the calendar year deferred.
- Earnings are taxable in the year they are distributed.
- There is no 10% early distribution tax, no 20% withholding, and no spousal consent requirement on amounts timely distributed.

Consequences of an untimely distribution.

- Under 401(a)(30) if the excess deferrals arise under one or more plans of the employer and these excess deferrals are not withdrawn by April 15, each affected plan of the employer is subject to disqualification and would need to go through EPCRS.,
- Under EPCRS, these excess deferrals are still subject to double taxation; that is, they are taxed both in the year contributed to the plan and in the year distributed from the plan.
- These late distributions could be subject to the 10% early distribution tax, 20% withholding, and spousal consent requirements.

Excess deferrals distributed to HCEs are included in the ADP test in the year such amounts were deferred. Excess deferrals distributed to NHCEs are not included in the ADP test as long as all deferrals were made under a plan or plans of one employer. Excess deferrals not timely distributed by April 15 are included in annual additions for the year deferred.

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<u>How to Identify the Mistake:</u>

You need to ensure that the section 402(g) limit for an applicable year is not exceeded by any participant. The amount of elective deferrals should be compared to the section 402(g)(1) limit. If the section 402(g) limit is surpassed by any participant during the year and not corrected, there could be a violation of Code section 401(a)(30), which could cause your plan to become disqualified.

<u>Section 402(g)(1) limit:</u>

- For 2004 and prior years, please refer to the cost of living adjustment (COLA) table
- 2005: $14,000
- 2006: $15,000
- 2007: $15,500

<u>Catch-up contribution limit:</u> **see above discussion**

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<u>How to Correct the Mistake:</u>

Section 72(t) of the Code imposes a 10% additional tax for taxable distributions that do not meet one of the exceptions provided for under the Code, such as death, disability, or attainment of age 59 ½, among others. In order to avoid the tax under section 72(t) of the Code, a section 401(a)(30) mistake should be corrected not later than the first April 15th following the close of the year. If correction is not made timely, the plan sponsor may still correct this mistake under EPCRS; however, making the corrections under EPCRS will not prevent the payment of any 72(t) tax resulting from the mistake.

- Under EPCRS, Appendix A, section .04, of Rev. Proc. 2006-27, the permitted correction method is to distribute the excess deferral to the employee and to report the amount as taxable **both** in the year of deferral and in the year distributed as provided by the Code and regulations under § 402(g). These amounts are reported on Form 1099-R.

Distributions of excess deferrals made after April 15 to an HCE are included in the ADP test for the year of deferral. Distributions to a NHCE are not included in the ADP test.

<u>Example:</u>
Employer X maintains a profit-sharing plan with a section 401(k) feature. There are 21 participants in the plan. For calendar year 2005, Participant B defers $16,000 to the plan. Participant B is under age 50 and thus is not eligible to make catch-up contributions. Participant B has excess deferrals of $2,000 because $14,000 is the section 402(g) maximum amounted permitted for 2005 ($16,000-$14,000= $2,000). Employer X does not discover this mistake until after April 15, 2006. On November 1, 2006, X distributes the excess deferral (plus applicable earnings of $100, totaling $2,100) to Participant B.

For 2005 (year of deferral), Participant B must include **$2,000** in gross income. For 2006 (year of distribution), Participant B must include **$2,100** in gross income. This amount would be shown on a Form 1099-R and Participant B must also pay the section 72(t) tax.

Return to Table

Correction Program(s) Available:

SCP:
The example illustrates an operational problem, in that the employer failed to follow the terms of the plan that prohibit the elective deferrals of any employee from exceeding the section 401(a)(30) limit. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer X may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
    - A corrective distribution needs to be made by December 31, 2007.
    - If not corrected by December 31, 2007, Employer X is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2007, SCP may only be used provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate**,** Employer X can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer X makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $1,000 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer X and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

You should work with your plan administrator to ensure the administrator has sufficient payroll information to verify that the deferral limitations of section 402(g) were satisfied. Procedures should be in place to ensure that, based on the participant election forms (including modifications), the section 402(g) limit will not be exceeded. Also, there should be checks and balances in place to alert you and your TPA when a participant does exceed the limit so corrective action may be taken on a timely basis.

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8) Have you timely deposited employee elective deferrals?

The employer is responsible for making contributions to the trust for the amounts of the elective deferrals made by the plan participants. To the extent your plan document contains language regarding the timing of deposits of elective deferrals, failure to follow the terms of the plan document can be corrected under EPCRS. However, this type of mistake can also lead to another problem – it may give rise to what is referred to as a "prohibited transaction." A prohibited transaction is a transaction between a plan and a disqualified person that is prohibited by law. An employer is considered to be a disqualified person.

Prohibited transactions generally include the following transactions:

- a transfer of plan income or assets to, or use of them, by, or for the benefit of, a disqualified person;
- any act of a fiduciary by which plan income or assets are used for his or her own interest;
- the receipt of consideration by a fiduciary, for his or her own account, from any party dealing with the plan in a transaction that involves plan income or assets;
- the sale, exchange, or lease of property between a plan and a disqualified person;
- lending money or extending credit between a plan and a disqualified person; and
- furnishing goods, services, or facilities between a plan and a disqualified person.

A prohibited transaction gives rise to an excise tax. A disqualified person who takes part in a prohibited transaction must correct the transaction and must pay an excise tax based on the amount involved in the transaction. The initial tax on a prohibited transaction is 15% of the amount involved for each year (or part of a year) in the taxable period. If the transaction is not corrected within the taxable period, an additional tax of 100% of the amount involved is imposed.

Department of Labor (DOL) rules require that elective deferrals be made to the plan on the earliest date that the amount can be segregated from the employer's general assets; however, in no event can the amount be deposited later than the 15th day of the following month. Keep in mind that the rules regarding the 15th day of the following month do not provide a safe harbor for depositing deferrals; rather, it sets the maximum deadline for deposit.

If the employer does not make the deposits timely, the failure may constitute both an operational mistake giving rise to plan disqualification (if the plan specifies a date by which elective deferrals must be deposited by the employer) and a prohibited transaction. Although the operational mistake can be corrected under EPCRS, correction of a prohibited transaction is not one of the correctable mistakes under EPCRS. However, the Department of Labor's Employee Benefits Security Administration (EBSA) maintains a Voluntary Fiduciary Correction Program (VFCP), which may be able to resolve the prohibited transaction.

Rules governing the timing of matching contributions or other employer contributions are different than those for elective deferrals. The following rules must be met in order for the employer to obtain a current tax deduction. Contributions made by the employer to match part or all of the participant's elective deferral may be made at the time of the elective deferral contribution or later, but in no event later than the due date of the employer's income tax return, including extensions. A 401(k) plan may have other employer contributions. Employer contributions that are not tied to elective deferrals must be made no later than the due date of the employer's tax return, including extensions. Review your plan document for the timing and amount of your matching contributions and other employer contributions.

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How to Identify the Mistake:

You should review plan terms relating to the timely deposit of elective deferrals and determine if they have been followed. Although it is not common, some plan documents contain a specific time for deposits. For example, if the plan document states the deposit will be made on a weekly basis (coincident with payroll), but deposit(s) are made on a biweekly basis, you may have an operational mistake requiring correction under IRS' EPCRS. In this simple example, your mistake would be not operating the plan in accordance with the plan document, which is correctable under EPCRS.

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How to Correct the Mistake:

Corrective Action:
Correction through EPCRS may be required if the terms of the plan were not followed. Correction for late deposits may require you to:

- Determine which deposits were late and calculate the lost earnings necessary to correct.
- Deposit any missed elective deferrals into the trust, along with lost earnings.
- Review procedures and correct deficiencies that led to the late deposits.

Example:
Employer B sponsors a 401(k) plan for its 1,200 employees, all of whom are participants in the plan. Employees are paid on the first day of the month. The plan **expressly** provides that deferrals are to be deposited within five days after each payday. B conducts a yearly compliance audit of its plan. During this review, it was discovered that elective deferrals were deposited 30 days after each payday for the 2006 plan year.

Return to Table

Correction Program(s) Available:

This operational mistake is correctible under EPCRS. Since the deposits were not made within the time required by the plan document, EPCRS is available for correction.

SCP:
The example illustrates an operational problem, in that the employer failed to follow the terms of the plan relating to the timing for depositing elective deferrals. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer B may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - A corrective contribution needs to be made by December 31, 2008.
  - If not corrected by December 31, 2008, Employer B is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2008, SCP may only be used provided the other requirements of SCP are satisfied.
- If the mistakes are **insignificant** in the aggregate, Employer B can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer B makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $15,000 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer B and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

Establish a procedure whereby elective deferrals are deposited coincident with or after each payroll in accordance with the plan document. If you have instances where your deferral deposits are a week or two later than the normal timely deposit (due to vacations or other disruptions, for example), keep a record of why those deposits were late. Coordinate with your payroll provider and others who provide service to your plan (if any) to determine the earliest date deferral deposits can reasonably be made. The date and related deposit procedures should match your plan document provisions, if any, dealing with this issue. If you have a change in the persons in charge of making these deposits, make certain the new person has a full understanding of when these deposits must be made.

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9) If the plan was top-heavy, were the required minimum contributions made to the plan?

In addition to ADP and ACP tests for 401(k) plans, there are other tests that should be performed annually, such as the tests associated with the top-heavy rules. These rules must be adhered to on an annual basis to ensure that the lower paid employees receive a minimum benefit if the plan is top-heavy. A plan is top-heavy when, as of the last day of the preceding plan year, the aggregate value of the plan accounts of key employees (as defined below) exceeds 60% of the aggregate value of the plan accounts for all employees under the plan.

If a 401(k) plan is determined to be top-heavy, an employer contribution of up to 3% must be made on behalf of all non-key employees still employed on the last day of the plan year. This contribution is subject to an accelerated vesting schedule requiring participants to be 100% vested after three years; or 20% after 2 years, 40% after 3, 60% after 4, 80% after 5, and 100% after 6 years.

To properly determine if your plan is top-heavy, you must first identify key employees. A key employee is an employee (including former or deceased employees), who at any time during the plan year was:

- An officer whose annual compensation from the employer exceeds $145,000 (2007);
- A 5% owner of the business (a 5% owner is someone who owns **more** than 5% of the business), **or**
- An employee owning more than 1% of the business and whose compensation exceeds $150,000 for the plan year.

It is important to note the distinction between key employees, who count for top-heavy purposes and highly compensated employees (HCEs) who count for the ADP and ACP tests but not the top-heavy tests. Also, a non-key employee is any employee who is not a key employee.

Remember, when you're determining ownership interests, family aggregation rules apply. These family aggregation rules may affect the treatment of stock owned directly or indirectly by family members. Any individual who is a spouse, child, grandparent, or parent of someone who is a 5% owner, or who together with that individual would own more than 5% of a company's stock, is treated as a 5% owner. As a 5% owner, each of these individuals would also be considered a key employee for the plan year. It's important to identify the family ownership interests of all company stock and to forward that information to your TPA, advisor, or persons performing the nondiscrimination tests.

SIMPLE 401(k) plans and certain safe harbor 401(k) plans are not subject to the top-heavy rules.

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How to Identify the Mistake:

Review the top-heavy rules and definitions found in your plan document. Make the determination as to whether or not your plan is top-heavy for each plan year. Be careful to properly identify the owners and their family members that are employed by the employer and apply the family aggregation rules.

It is common for a 401(k) plan to be top-heavy, especially for smaller plans and plans with high turnover. If you've been operating a 401(k) plan that only covers you and your spouse, and you hire other employees who eventually become eligible under the plan, you probably will have to make required minimum contributions if the new employees are non-key employees.

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How to Correct the Mistake:

Corrective Action:
Under EPCRS, Appendix A, section .02, the permitted correction method for failure to provide the minimum top-heavy contribution is to:

- Identify the affected employees, and
- Properly contribute and allocate the required top-heavy minimum, adjusted for earnings, to the affected non-key employees.
- Top-heavy minimums in a 401(k) plan are equal to 3% of compensation. However, if the highest percentage of contribution for a key employee is less than 3%, the top-heavy minimum is equal to that percentage.

Example:
Employer J, a husband and wife business, have sponsored a 401(k) plan for themselves since 2002. As business expanded, they hired two other employees on July 31, 2003. According to the terms of the plan document, both these new employees became eligible for the 401(k) plan on January 1, 2005. Both new employees made elective deferrals to the plan and it passed the ADP test for both 2005 and 2006. During a review of the plan, Employer J determined the plan was top-heavy for the 2005 and 2006 plan years; however, minimum top-heavy contributions were not made.

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Correction Program(s) Available:

SCP:
The example illustrates an operational problem, in that the employer failed to follow the top-heavy provisions of the plan. Therefore, provided that the other eligibility requirements of SCP are satisfied, Employer J may use SCP to correct the failure.

- No fees for self correction.
- Practices and procedures must be in place.
- If the mistakes are **significant** in the aggregate:
  - Corrective contributions for the 2005 plan year need to be made by the end of 2007. The corrective contribution for the mistake that occurred in 2006 needs to be made by December 31, 2008.
  - If these corrective contributions are not made by the above dates, Employer J is not eligible for SCP and must correct under VCP. Even if correction is made by December 31, 2008, SCP may only be used provided the other requirements of SCP are satisfied.

If the mistakes are **insignificant** in the aggregate, Employer J can correct beyond the two-year correction period for significant errors. Whether or not a mistake is insignificant is dependent on all the facts and circumstances.

VCP:
Under VCP, correction is the same as described above under SCP. Employer J makes a VCP submission in accordance with Rev. Proc. 2006-27. The fee for the VCP submission is $750 (per table in Sec. 12.02 of Rev. Proc. 2006-27).

Audit CAP:
Under Audit CAP, correction is the same as described above under SCP. Employer J and the IRS enter into a closing agreement outlining the corrective action and negotiate a sanction based on the Maximum Payment Amount (MPA.).

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How to Avoid the Mistake:

A top-heavy test should be performed each year. Also, care should be taken to properly identify ownership interests under the family aggregation rules so that the test is accurate. Be especially careful if you have a smaller plan or one that only covered owners for a period of time and now has other participants.

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10) Were hardship distributions made properly?

A 401(k) plan may allow employees to receive a hardship distribution because of an immediate and heavy financial need. Hardship distributions from a 401(k) plan are limited to the amount of the employee's elective deferrals and generally do not include any income earned on the deferred amounts. Hardship distributions cannot be rolled over to another plan or IRA. A distribution is treated as a hardship distribution only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution is made both on account of an immediate and heavy financial need of the employee and is necessary to satisfy that financial need**.** Whether an employee has an immediate and heavy financial need is to be determined based on all relevant facts and circumstances; however, a distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for:

- Expenses for medical care previously incurred by the employee, the employee's spouse, or any dependents of the employee or necessary for these persons to obtain medical care;
- Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);
- Payment of tuition, related educational fees, and room and board expenses, for the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents;
- Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;
- Funeral expenses for the employee's deceased parent, spouse, etc.; or
- Certain expenses relating to the repair of damage to the employee's principal residence.

Nearly all 401(k) plans contain the conditions above for determining whether a distribution is necessary to satisfy an immediate and heavy financial need of the employee. These rules are contained in the regulations under section 401(k) and they are designed to relieve the employer (and the employee) from looking to resources outside of the 401(k) plan.

Pursuant to the Pension Protection Act of 2006 (PPA), the deemed hardship rules described above have been modified to treat a participant's plan beneficiary the same as a participant's spouse and dependents for purposes of qualifying for a hardship distribution. In other words, a hardship distribution described in the 1st, 3rd and 5th bullets above can now be made to a participant based upon the need of a grandchild or domestic partner as long as that individual has been designated as a beneficiary under the plan. While you are not required to modify your plan to include this change, nonetheless, this option is only available if your plan document was amended to include this new PPA language.

A distribution may not be treated as necessary to satisfy an immediate and heavy financial need:

- If the distribution is in excess of the amount needed to relieve the financial need of an employee, or
- If the financial need may be satisfied from other resources that are reasonably available to the employee.

This determination generally is to be made on the basis of all relevant facts and circumstances. The employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. The amount of an immediate and heavy financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

An immediate and heavy financial need generally may be treated as not capable of being relieved from other resources reasonably available to the employee if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved:

- Through reimbursement or compensation by insurance or otherwise;
- By liquidation of the employee's assets;
- By cessation of elective deferrals or employee contributions under the plan; or
- By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer, or by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

A need cannot reasonably be relieved by one of the actions listed above if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

Record keeping is an important area that is commonly neglected. It's important that plan sponsors keep a record of all information used to determine whether a participant was eligible for a hardship distribution and the amount distributed was the amount necessary to alleviate the hardship. Hardship distributions may be subject to the 10% early distribution tax on distributions made prior to reaching age 59 ½.

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How to Identify the Mistake:

Review your plan document to determine if it allows for hardship distributions, then review your 401(k) plan's hardship procedures. If you don't have procedures for reviewing hardship applications, establish them. This may require the help of a benefits professional.

Review all distributions made during the year and determine which may have been a hardship distribution. Distributions to participants who continue to be employees are very limited, so start your review with those distributions. For each of the hardship distributions, make a determination whether each one met the hardship distribution requirements set forth in the plan document. Look for abuse of the hardship feature. Almost anyone can find themselves in need of a financial bailout; however, if most of your hardship requests come from a specific group of employees, you may have some participants abusing the plan's hardship feature.

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How to Correct the Mistake:

Corrective Action:
In our discussion of mistakes involving hardship distributions, we'll focus on mistakes involving plan document issues and distributions not meeting the hardship requirements.

- The plan document does not allow for hardship distributions, but in operation, hardship distributions do occur.
    - Correction may involve a retroactive amendment to allow hardship distributions.
- Hardship distributions are made to participants that don't meet the hardship requirements of the plan document or section 401(k).

- Correction may involve a repayment to the plan of the amounts that did not meet the hardship requirements of the plan or section 401(k).

Example 1:
Employer L maintains a 401(k) plan with 40 participants. Plan provisions do not allow for hardship distributions. Hardship distributions were made to a number of employees during the 2004 and 2005 plan years. During a review of its plan's operations, Employer L determined that these hardship distributions were in fact made available to all employees and the standards under the Code for hardship distributions were met.

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Correction Program(s) Available:

SCP:
This mistake would be considered to be an operational error. If L determines it has established practices and procedures in place to promote the overall compliance of their plan, it may correct the plan mistake under SCP. Although in general correction of an operational error through an amendment to the plan is not permissible under SCP, the provision of hardship withdrawals under the plan in a nondiscriminatory manner is one of four instances in which a corrective amendment would be allowed under SCP.

Correction would include adopting a retroactive plan amendment, effective January 1, 2004, to provide for the hardship distributions that were made available. The amendment must provide that the hardship distribution option is available in a nondiscriminatory manner.

VCP:
Employer L may also correct the mistake under VCP by adopting a retroactive plan amendment, effective January 1, 2004, to provide for the hardship distributions that were made available. The amendment must provide that the hardship distribution option is made available in a nondiscriminatory manner

The fee for a 40 person plan is $1,000.

Audit CAP:
This error can also be corrected under Audit CAP. See example 3 below for a discussion of Audit CAP.

Example 2:
Same facts as in Example 1, except the distributions were not made available to all employees and the only hardship distribution was made to a HCE.

Correction Program(s) Available:

SCP:
Since hardship distributions were not made available to all employees, correction by retroactive amendment under SCP is not available. A correction that is reasonably designed to facilitate overall compliance in accordance with the principles in Section 6 of Rev. Proc. 2006-27 will be permitted.

VCP:
Employer L may correct the mistake under VCP. However, since the hardship distributions were not made available to all employees and in fact were only made

available to select HCEs, a retroactive plan amendment is not permitted to correct this mistake because it will not satisfy the nondiscrimination rules. A correction that is reasonably designed to facilitate overall compliance in accordance with the principles in Section 6 of Rev. Proc. 2006-27 will be permitted.

The fee would be the same as in Example 1 ($1,000).

Audit CAP:
This error can also be corrected under Audit CAP. See example 3 below for a discussion of Audit CAP.

Example 3:
Employer M maintains a 401(k) plan with 7,500 participants. Plan provisions allow for hardship distributions to participants. During a review of its operations, Employer M determined that 10 hardship distributions made during the 2005 plan year did not have proper documentation. Further investigation by M revealed that five of the distributions were not based on any hardship, but were nothing more than in-service distributions. There were no written procedures in place to review a participant's application for a hardship distribution.

Correction Program(s) Available:

SCP:
This mistake may not be eligible to correct under SCP since there were not adequate policies and procedures in place with regard to hardship distributions.

VCP:
Employer M may correct this mistake under VCP. The five participants who received distributions that did not meet the hardship requirements of the plan must be requested to repay the amounts plus earnings to the plan. In addition, the plan's administrative procedures regarding hardships must be improved. As in Example 2 above, expecting these amounts to be repaid to the plan in full may be problematic because the funds may have already been spent by the participants. A plan document requiring spousal consents for distributions, plus possible tax issues on the distributions could further complicate the final correction. Correction will depend on all the facts and circumstances of each individual situation and may include, in some form, paybacks, employer corrective contributions, and even some form of plan amendment. If this represents your situation, file a VCP application and work with the Voluntary Correction agent to determine the proper correction.

The fee for a 7,500 person plan is $20,000.

Audit CAP:
Most plans are eligible for Audit CAP, which allows the plan sponsor to correct the mistake and pay a negotiated sanction. This sanction will bear a reasonable relationship to the nature, extent, and severity of the mistake, taking into account many factors, including the extent to which correction occurred before audit. Sanctions under Audit CAP are a negotiated percentage of the Maximum Payment Amount (MPA).

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How to Avoid the Mistake:

Administering a hardship distribution program may be complicated, but knowing their 401(k) accounts can be used in times of a financial emergency may make it easier for rank-and-file employees to build their retirement accounts. As with many mistakes, employers with a better understanding of their plan document make fewer mistakes. What follows are a few things you can do to cut down on mistakes in this area:

- Review the language in your plan document to determine when and under what circumstances distributions can be made.
- When your plan document is amended, make certain the language regarding hardship distributions is contained in the most recent document.
- Establish hardship distribution procedures. Work with your benefits professional (if any) to determine if they are sufficient to avoid mistakes.
- Only allow hardship distributions that meet the requirements of section 401(k) of the Code and your plan document.
- Look for signs that the hardship distribution program is being abused or badly managed.
    - Too many hardship requests by one group or division may be a sign of abuse.
    - Requests for hardship distributions from multiple employees look identical. Each situation should have its own individual circumstances.
    - Only the highly compensated employees have hardship distributions. This may be a sign that rank-and-file employees have not been properly notified of the availability of hardships.

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11) Have you filed a Form 5500 series return, and have you distributed a Summary Annual Report (SAR) to all plan participants this year?

Under the Employee Retirement Income Security Act (ERISA), employers and plan administrators are required to submit reports to government agencies and furnish certain plan information to participants. A Form 5500, *Annual Return/Report of Employee Benefit Plan, is* generally required to be filed each year for an employee benefit plan subject to ERISA. Most employers that sponsor a qualified retirement plan, such as a 401(k) plan, are required to file this return. For an expanded explanation of how to file your Form 5500 return, along with the EFAST electronic filing requirements, please visit www.efast.dol.gov.

In addition to the Form 5500, certain other plan information must be made available to participants. Following is a list of documents that must be made available to participants and beneficiaries:

- Summary Plan Description (SPD) – This plain language explanation of the plan must be comprehensive enough to apprise participants of their rights and responsibilities under the plan. Among other things, the SPD must include information about:
    - When and how employees become eligible to participate,
    - The source of contributions and contribution levels,
    - Vesting – the length of time an employee must be in the plan to receive benefits,
    - How to file a claim for those benefits,
    - Participant's basic rights and responsibilities under ERISA.

This document must be given to your employees after they join the plan and to beneficiaries after they first receive benefits. SPDs must also be redistributed periodically and provided on request.

- Summary of Material Modification (SMM) – Apprises participants and beneficiaries of changes to the plan or to information required to be in the SPD. The SMM or an updated SPD must be provided to the participants and beneficiaries within 210 days after the end of the plan year in which the change was adopted.
- Summary Annual Report (SAR) – Outlines in narrative form the financial information in the plan's Annual Report, the Form 5500, and must be furnished annually to participants.
- Individual Benefit Statement – Provides participants with information about their account balances and vested benefits. For plans sponsored by a single employer, the statement must be provided when a participant submits a written request, but no more than once in a 12-month period, and automatically to certain participants who have terminated service with the employer.
- Blackout Period Notice – For profit-sharing plans with or without a 401(k) feature, requires at least 30 days (but not more than 60 days) advance notice before a plan is closed to participant transactions. During blackout periods, participants and beneficiaries cannot direct investments, take loans, or request distributions. Typically, blackout periods occur when plans change record keepers or investment options, or when plans add participants due to a corporate merger or acquisition.

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How to Identify the Mistake:

Many employers identify the mistake when they receive a letter from IRS or DOL stating the Form 5500 series return was never filed. It's normally a year after it was due and includes a substantial fine. Late filed returns are subject to penalties from both IRS and DOL, so it's very important you identify this mistake before we do. Following are the penalties:

- The IRS penalty for late filing of a return is $25 per day, up to a maximum of $15,000.
- The DOL penalty for late filing can run up to $1,100 per day, with no maximum.

To identify this mistake before we do, find your signed copy of the return and determine if it was timely filed.

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How to Correct the Mistake:

- Correction of a late filed Form 5500 is not available under EPCRS. If you determine your Form 5500 series return was not filed, the correction is filing the delinquent return. It's very important you file the delinquent return as soon as possible. DOL maintains a Delinquent Filer Voluntary Correction Program (DFVC). However, DFVC is not available for Form 5500-EZ filers.

- IRS is responsible for determining any late filer penalty for a Form 5500-EZ.
  - Submit a reasonable cause statement with the late Form 5500-EZ explaining why the return was late.

- IRS will review the reasonable cause statement and may reduce or waive the late filer penalty.

Example:
Employer Z sponsors a 401(k) for its employees and failed to file a Form 5500 series return for the 2005 year.

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Corrective Action:
Failing to properly file a Form 5500 return is not correctable under EPCRS. If the IRS reaches out to you regarding a delinquent Form 5500 series return, you may file it in response to the letter. Include an explanation as to why the return wasn't filed and request a waiver of the penalty. In addition, the Department of Labor has a Delinquent Filer Voluntary Correction Program (DFVC).

If Employer Z sponsors a one-participant plan required to file a Form 5500-EZ return, DFVC is not available for such plans. Form 5500-EZ filers are subject to the IRS penalties of $25 per day, up to $15,000. Form 5500-EZ filers should file the delinquent Form 5500-EZ return immediately, along with an explanation as to why the return wasn't filed and request a waiver of the penalty from the IRS.

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How to Avoid the Mistake:

The best way to avoid this mistake is to understand your responsibilities and to file the return. Never assume someone else is filing this for you. Each plan may have a number of individuals providing service to the plan, from the CPA, to the TPA, benefits attorney, auditor, inside auditor, human resource employees, banker, financial advisor, etc. As the plan administrator, you have the responsibility for making certain the return is properly filed.