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IRS Eases Correction Rules for Missed Elective Deferrals

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The IRS has just given sponsors of 401(k) and 403(b) plans a number of additional options for correcting a failure to honor an employee's election to defer a portion of his or her pay. These new options, as announced in Revenue Procedure 2015-28, will be particularly helpful to sponsors of plans that provide for automatic enrollment (including those with an "automatic escalation" feature).

According to the IRS, these new options respond to concerns that the costs of correcting missed elective deferrals have discouraged employers from moving to automatic enrollment and/or escalation. And in fact, we do seem to be seeing more operational errors associated with these features. Perhaps it requires more coordination between an employer's various departments to successfully implement an automatic enrollment and/or escalation feature than it does to honor *affirmative* deferral elections. In any event, the IRS has made no secret of its desire to encourage the adoption of these features. Hence this latest relief.

New Safe Harbor for Automatic Enrollment or Escalation

An employer's failure to deduct employee deferrals in accordance with an automatic enrollment or escalation feature often requires the employer to make substantial corrective contributions on behalf of the affected employees. In part, this is because employees pay less attention to automatic enrollments than to their affirmative deferral elections – thereby allowing this operational failure to continue until it is detected by the plan's independent auditor. And that may not occur until many months after the close of the plan year, when the audit must be prepared and attached to the plan's Annual Report.

This latest relief therefore includes a new safe-harbor correction method that is expressly tied to the deadline for filing a plan's Annual Report (generally, 7 months after the close of a plan year, but with an automatic 2 ½-month extension). Under this safe harbor, an employer that has failed to implement an automatic enrollment or escalation feature need not make up the missed deferrals – *so long as* the employer starts to deduct the appropriate deferrals from employees' paychecks by the first pay day after the 9 ½-month period allowed for filing the plan's Annual Report for the year of the failure. This could allow an employer to avoid making corrective contributions for up to 21 ½ months of an employee's pay.

Moreover, this safe harbor applies even with respect to employees who have made *affirmative* deferral elections (which were not honored), *if* those employees were otherwise subject to an automatic enrollment or escalation provision. This extended safe-harbor period may be cut short if an employee notifies the employer that his or her deferral election (including a *default* election) is not being honored. In that event, the employer must start deducting the appropriate deferrals by the first pay day on or after the last day of the following month.

To rely on this new safe harbor, an employer must notify all affected employees within 45 days after their deferrals commence. This notice must describe both the failure and its correction. The Revenue Procedure outlines the specific information to be included in this notice.

The employer must also make any *matching* contributions that would have been made if the employees' deferrals had commenced at the appropriate time. The deadline for making these retroactive matching contributions is the close of the second plan year after the plan year in which the operational failure occurred. This is the deadline for correcting "significant" operational failures under the IRS's Self-Correction Program. (As noted below, this "SCP Deadline" is a recurring theme throughout the new Revenue Procedure.)

Any matching contributions must also be adjusted for lost earnings. In addition to the existing options for calculating lost earnings (as outlined in Section 3 of Appendix B to Revenue Procedure 2013-12), this Revenue Procedure adds one more option that applies solely to employees who have never made an investment election (as is typical for an automatic enrollment failure). In this circumstance, the employer may calculate lost earnings on the basis of the plan's default investment option – so long as the matching contribution is not reduced for any net losses.

Other Correction Options for Missed Deferrals

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The Revenue Procedure also provides two additional correction options that apply to *all* failures involving missed deferrals – regardless of whether the failure involves an automatic enrollment or escalation feature. One such option applies if a failure is detected relatively rapidly, while the other applies more broadly.

Existing Correction Rules. Prior to this Revenue Procedure, an employer that was lucky enough to detect a failure to honor an employee's deferral election within the first three months of a plan year could avoid having to correct those missed deferrals – assuming the employee had the ability, over the remainder of the plan year, to make the full annual deferral and receive the full annual match. However, this exception to the corrective contribution requirement did not apply if the failure was detected during the last nine months of a plan year – even if the failure had lasted for less than three months.

Apart from that narrow three-month exception, an employer that had failed to honor a deferral election was required to make a special corrective contribution equal to 50% of the deferrals that would have been made on an employee's behalf had the employee's election been honored. (This contribution was set at only 50% of the missed deferrals because the employee actually received – on a taxable basis – the amount that should have been deducted from his or her pay.)

Rolling Three-Month Exception. The Revenue Procedure converts the existing three-month exception into a *rolling* three-month provision. So long as elective deferrals commence within three months of when they *should* have commenced – regardless of where that falls during a plan year – an employer need not make up the missed deferrals. (If the affected employee notifies the employer sooner, the deferrals must commence by the last day of the month following the month in which the employer receives this notice.)

This expanded three-month exception does nothing to shield an employer from having to make up any *matching* contributions that an employee would have received if the missed deferrals had actually been made. Such a corrective match, as adjusted for lost earnings, must be made by the SCP Deadline. And affected employees must be notified of the failure and its correction within the 45-day period described above.

Failures Lasting More than Three Months. The other new correction method applies to operational failure lasting *more* than three months – but only if an employer begins deducting the proper elective deferrals from an employee's pay by the SCP Deadline. In this case, the employer does not get a "free pass" on the missed deferrals. However, instead of contributing **50%** of those missed deferrals, the corrective contribution need only be **25%** of that amount.

The employer must also make the full amount of any matching contributions. Those contributions, along with the corrective contribution equal to 25% of the missed deferrals, must be adjusted for lost earnings. All of these contributions must be made by the SCP Deadline. And the affected employees must also receive the 45-day notice.

Sunset Provision; Effective Date

Interestingly, the new safe harbor for automatic enrollment or escalation plans carries a "sunset" date of December 31, 2020. That is, unless further guidance is issued before that date, that safe harbor will cease to apply to *subsequent* operational failures. Given the history and trajectory of the IRS correction programs, however, it seems unlikely that the IRS would let this new option expire.

The Revenue Procedure carries an effective date of April 2, 2015, so these new correction options are immediately available. It appears that they may even be applied to failures occurring *before* that date. Employers that have been "on the fence" as to whether to correct a failure to honor one or more deferral elections will thus want to take this latest guidance into account when arriving at a final decision.

Moreover, given the extraordinarily generous safe harbor for automatic enrollment or escalation failures, sponsors of 401(k) or 403(b) plans may want to take a closer look at implementing these features.