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Employee Benefits Corner

Correction of Missed Deferrals

By Elizabeth Thomas Dold and David N. Levine

Compliance with a participant's deferral election is one of the most common failures that occurs with 401(k) and 403(b) plans. There can be any number of reasons why a plan sponsor has failed to comply with the participant's affirmative or automatic deferral election. Perhaps the plan is not using the correct definition of compensation or is excluding employees that are eligible to participate in the plan (*e.g.*, long-term part-time employees, transferred employees, newly acquired employees, already satisfied eligibility requirements, *etc.*). Regardless of the reason, if the plan sponsor (or recordkeeper) fails to provide the applicable deferral rate to the eligible compensation, this results in an operational failure for failure to follow the terms of the plan and raises plan qualification concerns if the error is not corrected.

The standard pre-approved correction methods for a 401(k)/403(b) plan are set forth in Rev. Proc. 2021-30 (EPCRS), as modified by Notice 2024-2. There are three methods of corrective contributions that may apply, depending on the circumstances:

- 50% of the missed deferral, and 100% of the missed match (both adjusted for missed earnings through the date of correction);
- 25% of the missed deferral, and 100% of the missed match (both adjusted for missed earnings through the date of correction); and
- 0% of the missed deferral, and 100% of the missed match (adjusted for missed earnings through the date of correction).

The 0% rate for the qualified nonelective employer contribution (QNEC) for automatic enrollment plans expired under EPCRS as of December 21, 2023. But Section 350 of SECURE 2.0 made the relief permanent, but with a few tweaks, as explained in Notice 2024-2. Chart 1 below summarizes the general rules that apply to correcting missed deferrals.

Notice 2024-2

Notice 2024-2, the so-called grab-bag guidance, included a number of important clarifications regarding the 0% QNEC rate for automatic enrollment plans. We would expect it would apply to plans subject to the new mandatory eligible automatic contribution arrangement (EACA) rules under Section 101 of SECURE 2.0, along with automatic contribution arrangement (ACA) and qualified automatic contribution arrangement (QACA) plans.

CHART 1.

	50% Rate	25% Rate	0% Rate*
Automatic Enrollment (AE) Required?	No	No	Yes (unless error corrected within 3 months)
Participant Notice Required (details in EPCRS—info on failure, corrective contribution, commencement of correct deferrals, opportunity to increase deferrals, and plan contact info)	No	Yes, within 45 days of starting correct deferrals	Yes, within 45 days of starting correct deferrals
Correct Deferrals Deadline	n/a	Earlier of first compensation that begins on or after (1) the end of the third plan year following the plan year in which the error occurred, or (2) the last day of the month following the month in which the employee notified the employer of the error	**For a 3-month correction (all plans):** Earlier of first compensation that begins on or after (1) 3 months after the error occurred, or (2) the last day of the month following the month in which the employee notified the employer of the error **For AE plans:** Earlier of first compensation that begins on or after (1) 9½ months after the plan year in which the error occurred, or (2) last day of the month following the month in which the employee notified the employer of the error
Match Contribution Timing	n/a	End of the third plan year after the plan year in which the error occurred	**For a 3-month correction (all plans):** End of the third plan year after the plan year in which the error occurred **For AE plans:** Last day of the sixth month following the month in which correct elective deferrals begin (unless an error occurred on or before 12/31/23, then the three-year period described above)

* Note that under EPCRS there is also a special rule for certain failures that occur within the first three months of the plan year that has a 0% QNEC for the missed deferrals. Also, for AE plans, the 0% rate applies for errors in implementing automatic enrollment and errors in implementing affirmative elections for participants who otherwise would have been subject to the automatic enrollment feature.

Specifically, the Notice clarified the following rules that are set forth in new Code Sec. 414(cc):

Compliance with a participant's deferral election is one of the most common failures that occurs with 401(k) and 403(b) plans.

Correction Window: The correction must be made by the earlier of (1) the date of the first payment of compensation made by the employer to the employee on or after the last day of the 9½-month period after the end of the plan year during which the error with respect to the employee first occurred, or (2) in the case of an employee who notifies the plan sponsor of the error, the date of the first payment of compensation made by the employer to the employee on or after the last day of the month following the month in which the notification was made.

Missed Match: In the case of an employee who would have been entitled to additional matching contributions had any missed elective deferrals been made, the plan sponsor must make a corrective allocation of matching contributions to which the employee would have been entitled (adjusted to account for earnings) had the missed elective deferrals been made not later than the deadline for allocating corrective matching contributions specified by the Secretary in regulations, or other guidance of general applicability.

Similarly Situated Participants: The error must be corrected for all similarly situated participants in a nondiscriminatory manner, and notice of the error must be given to employees affected by the error within 45 days after the date on which correct deferrals begin.

There are a number of available pre-approved correction options for missed deferrals, which are available for self-correction. Missed deferrals can occur in a number of different ways but the correction should be consistent for similarly situated participants.

Former Employees: This correction is available with respect to an individual even if the individual terminates employment before corrected deferrals would otherwise have begun. In general, the sponsor of a plan to which Code Sec. 414(cc) applies is permitted to correct an error with respect to both active and terminated employees by following the correction method referenced below. However, the notice provided to a terminated employee is not required to include the following information set forth in EPCRS (Appendix A, section.05(8)(c)): (1) a statement that appropriate amounts have begun to be deducted from compensation and contributed to the plan (or that appropriate deductions and contributions will begin shortly), or (2) an explanation that the affected terminated employee may elect an increased deferral percentage to make up for the missed deferral opportunity.

Correction Method: A plan sponsor may correct, pursuant to Code Sec. 414(cc), a deferral error by following the safe harbor correction method set forth in EPCRS (Appendix A, section.05(8)) for failures related to automatic contribution features. However, there is a special deadline for making the missed matching contributions. Specifically, a corrective allocation of matching contributions (adjusted for earnings) must be made within a reasonable period, as determined by applying all relevant facts and circumstances, after the date on which the correct elective deferrals begin (or, with respect to a terminated employee, would have begun but for the termination of employment). A corrective allocation of matching contributions that is made by the last day of the sixth month following the month in which correct elective deferrals begin (or, with respect to a terminated employee, would have begun but for the termination of employment) will be treated as having been made within a reasonable period. Conversely, if the error began on or before December 31, 2023, a corrective allocation of matching contributions made by the end of the third plan year following the year in which the error occurred will be treated as having been made within a reasonable period.

Effective Date: This new provision applies with respect to any errors for which the date referred to in Code Sec. 414(cc) is after December 31, 2023; prior to any regulations or other guidance under Code Sec. 414(cc) is issued, taxpayers may rely upon their reasonable good faith interpretations of this new provision.

For this purpose, "the date referred to in Code Sec. 414(cc)" is the date by which an employer must implement correct deferrals (or, with respect to a terminated employee, the date by which they would have been implemented but for the termination of employment). As described in the chart above, this date is the earlier of (1) the date of the first payment of compensation made by the employer to the employee on or after the last day of the 9½-month period after the end of the plan year during which an implementation error with respect to the employee first occurred, or (2) in the case of an employee who notifies the plan sponsor of the error, the date of the first payment of compensation made by the employer to the employee on or after the last day of the month following the month in which the notification was made. Therefore, the effective date may vary depending on the following factors: the date the error occurs, the date compensation is paid, whether the employee notifies the plan sponsor of the error, and whether the plan year is a fiscal year or calendar year. For example, Employer X sponsors a calendar year 401(k) plan that includes an automatic contribution enrollment feature. On January 1, 2023, Employer X fails to automatically enroll an eligible employee due to an error. The employee does not inform Employer X of the error, so Employer X has until the date of the first payment of compensation made by the employer to the employee on or after October 15, 2024 (the last day of the 9½-month period after the end of the 2023 plan year) to begin corrected elective deferrals. The date of the first payment of compensation made to the employee after October 15, 2024 is October 18, 2024. Because October 18, 2024 is after December 31, 2023, Code Sec. 414(cc) applies.

Self-Correction

Self-correction is available for the correction of missed deferrals, but if the plan sponsor is trying to do something more creative, a voluntary correction program (VCP) filing with the Internal Revenue Service (IRS) should be considered. Even if the failure is viewed as a significant violation,[1] based on the facts and circumstances, the error can still be self-corrected. This is true even if the error first occurred more than three years ago, but the correction rate may vary depending on how long the error has been ongoing, the type of plan, and the need to take corrective action within 18 months of identifying the error.

Conclusion

There are a number of available pre-approved correction options for missed deferrals, which are available for self-correction. Missed deferrals can occur in a number of different ways but the correction should be consistent for similarly situated participants. To the extent that the plan offers automatic enrollment, despite the faster timeline to make the missed match, a 0% QNEC for missed deferrals that applies to both active and terminated participants is always worth considering.

ENDNOTES

1 Examples of factors that are considered in determining if the error is insignificant or significant include:
- other failures that occurred during the year(s) being examined (for this purpose, a failure is not considered to have occurred more than once just because more than one participant is affected by the failure);
- the percentage of plan assets and contributions involved in the failure;
- the number of years the failure occurred;
- the number of participants affected compared to the total number of participants in the plan;
- the number of participants affected as a result of the failure compared to the number of participants who could have been affected by the failure;
- whether correction was made within a reasonable time after the failure is found; and
- the reason for the failure (for example, data errors or minor math errors).

This list does not contain all possible factors. No single factor is used to determine the significance of the failure. Failures will not be considered significant just because they occur in more than one year. In addition, the IRS will apply these factors in a way that will not prevent small businesses from being eligible for the self-correction just because of their size.