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Employee Benefit Plan Review

Ask the Experts

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Ability to Self-Correct 401(k) Plan Operational Failure

Q My company sponsors a 401(k) plan and, in the course of an internal audit, we recently discovered that there was a programming issue in our system that resulted in certain plan participants having an elective deferral contribution that is slightly less than what they had elected to defer. As a result, they also received lower employer matching contributions than they would have received if they had made the full elective deferral that they had elected. We have fixed the programming issue going forward, but we understand that we will need to correct this past mistake. Is this an issue that we can correct on our own, without making a filing with the Internal Revenue Service ("IRS") and/or paying fees and penalties?

A It depends. The IRS has a correction program, the Employee Plans Compliance Resolution System ("EPCRS"), pursuant to which plan sponsors may correct these types of failures. Under EPCRS, certain types of failures are eligible for employers to self-correct under the Self-Correction Program ("SCP") without making any filing to the IRS or paying any fee or penalties.

However, under the EPCRS, other types of failures require making a filing to the IRS and paying fees or penalties to make correction. For your plan's failure to be eligible for self-correction under the SCP, the following must generally apply:

- The plan sponsor or administrator must have established practices and procedures (formal or informal) reasonably designed to promote and facilitate overall compliance in form and operation with applicable Internal Revenue Code ("IRC") requirements.
- The operational failure generally must be fully corrected with respect to all participants and beneficiaries, and for all taxable years.
    - If it is possible to make a precise calculation but the probable difference between the approximate and the precise restoration of a participant's benefits is insignificant and the administrative cost of determining precise restoration would significantly exceed the probably difference, reasonable estimates may be used in calculating appropriate correction.
- The failure must either be "insignificant" (given all the facts and circumstances, and considering, without limitation, certain factors set forth in the EPCRS), or, if the failure is "significant," it must be corrected by the last day of the second plan year following the plan year for which the failure occurred.
- The operational failure must be corrected in accordance with the EPCRS. There may be several options for correction of the operational failure that you describe, depending on the facts and circumstances, including the following:

- *Safe Harbor Correction Method If Failure Does Not Exceed Three Months.* If there are any affected employees for whom the failure does not exceed three months, the employer can correct the failure without making a qualified non-elective contribution ("QNEC") for missed elective deferrals if certain conditions are satisfied, as set forth in the EPCRS. These conditions are generally as follows:
  - Correct deferrals must begin by the first payment of compensation made on or after the last day of the three-month period that begins when the failure first occurred for the affected eligible employee.
  - A notice of the failure that meets specified content requirements is given to the affected eligible employee no later than 45 days after the date on which correct deferrals begin.
  - The plan sponsor makes a corrective allocation (adjusted for earnings) on behalf of the employee equal to the missed matching contributions that would have been required under the terms of the plan. This contribution must be made by the end of the deadline for significant operational failures.
- *Safe Harbor Correction Method If Failure Extends Beyond Three Months But Does Not Extend Beyond the SCP Correction Period for Significant Failures.* If the failure extends beyond three months (or the conditions set forth above are otherwise not met), the employer can correct the failure under an alternate safe harbor under the EPCRS. The conditions are generally as follows:
  - The plan sponsor makes a corrective contribution equal to 25 percent of the missed deferrals (a 25 percent QNEC) to replace the employee's missed deferral opportunity, adjusted for earnings from the date of the failure.
  - Correct deferrals begin no later than the earlier of the first payment of compensation made on or after the last day of the second plan year following the plan year in which the failure occurred.
  - A notice of the failure that meets specified content requirements is given to the affected eligible employee no later than 45 days after the date on which correct deferrals begin.
  - The plan sponsor makes a corrective allocation (adjusted for earnings) on behalf of the employee equal to the missed matching contributions that would have been required under the terms of the plan.
  - The 25 percent QNEC and the employer contribution to make up for the missed match are made by the end of the deadline for significant operational failures.
- If the criteria for the aforementioned safe harbors are not met, there are additional safe harbor correction methods (that require higher QNEC amounts) under principles set forth in the EPCRS. Generally, these would require the plan sponsor to make a 50 percent QNEC for the missed deferral opportunity, adjusted for earnings, as well as a corrective employer nonelective contribution equal to the matching contribution the employee would have received had the employee made the deferral equal to the missed deferral amount (adjusted for earnings to the date the corrective contribution is made).

Over-the-Counter Drugs

Q My company sponsors a health flexible spending arrangement (health "FSA") for our employees. I read recently that employees are now permitted to pay for over-the-counter drugs from health FSAs. Is this correct? If so, when did this change take effect?

A It is correct and the change took effect January 1, 2020. The Coronavirus, Aid, Relief and Economic Security Act of 2020 ("CARES Act"), which was signed into law on March 27, 2020, permits health FSAs, health savings accounts ("HSAs"), Archer medical savings accounts ("Archer MSAs"), and health reimbursement arrangements ("HRAs") to reimburse over-the-counter ("OTC") products and medicines that are available without a prescription.

Before the CARES Act was enacted, the Patient Protection and Affordable Care Act ("ACA") generally prohibited health FSAs, HSAs, Archer MSAs, and HRAs from reimbursing OTC products and medicines unless they were prescribed by a physician or other authorized health care provider.

There was an exception for insulin and OTC products and medicines that were prescribed. Although the

CARES Act would permit reimbursement of non-prescription OTC products and medicines, this change is permissive rather than mandatory, meaning that your company may choose whether to reimburse these expenses. You should review your health FSA document to determine whether any amendments to the document or participant communications are recommended or needed.

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