

A MISTAKE A DAY: TOP 5 401(K) COMPLIANCE MISTAKES & BEST PRACTICES

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Welcome to the third installment of this series! This week, we are discussing the five most common compliance mistakes made by 401(k) plan administrators and fiduciaries, the potential liability associated with such mistakes, and steps you can take to avoid making them yourself. Each day we will discuss a new compliance mistake. So far, we have discussed [failures to timely update plan documents](#) and an SPD's [failure to accurately describe plan terms](#). Today we discuss a plan's definition of compensation.

Wrong Definition of Compensation

Description

401(k) plans may use different definitions of compensation for different purposes. For instance, plans may use any definition of compensation for certain purposes, but must use one of two statutory definitions of compensation found in the Internal Revenue Code ("IRC") for certain other purposes. For example, (i) the IRC § 415 definition of compensation must be used when calculating the employer's deduction for contributions and determining which employees are considered highly compensated, and (ii) the IRC § 414 definition of compensation must be used for safe harbor plans and for determining if a plan meets nondiscrimination requirements. An operational failure occurs when the administrator uses a definition of compensation other than the definition specified in the plan documents. Even if the definition used for the calculation is legally permissible, the definition must match the definition contained in the plan's terms.

Potential Liability

If the error is discovered by the plan sponsor, it may generally be corrected as described below. If the error is discovered by the IRS, the plan sponsor will need to correct in much the same manner as described below, but it will also pay a significantly steeper penalty.

Example

A plan document specifies that compensation includes base salary plus bonuses for purposes of calculating the employer's matching contributions. The employer calculates the matching

contribution based solely on base salary. The employer used a permissible definition of compensation to calculate its matching contribution—but it nevertheless has an operational failure because it used a definition different from the one specified in the plan document.

The Fix

The simplest way to avoid errors based on an incorrect definition of compensation is to make sure that all vendors and employees involved in administering the plan (HR, payroll and IT) are familiar with that definition. Pay particular attention when switching plan administrators or payroll vendors, when modifying payroll programs, or when restating or amending the plan document. These are the circumstances in which failures commonly occur. Also, review regularly for compliance because compensation failures can be self-corrected with relatively little difficulty if discovered early. The Employee Plans Compliance System (“EPCRS”) provides an avenue for self-correction of these (and many other) types of errors. Correction typically requires that the sponsor pay a penalty and take steps to put participants and the plan in the position they would have been had the correct definition of compensation been used. This often requires additional contributions to the plan or distributions to participants, in each case adjusted as appropriate for earnings.

RELATED PRACTICE AREAS

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MEET THE TEAM



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