

Part III---Administrative, Procedural and Miscellaneous

26 CFR 601.202: Closing Agreements.

Rev. Proc. 99-31

TABLE OF CONTENTS

SECTION 1. PURPOSE AND BACKGROUND

- .01 Purpose
- .02 Background
- .03 Overview
- .04 Request for Comments

SECTION 2. EFFECT OF THIS REVENUE PROCEDURE; RELIANCE

- .01 Effect of this Revenue Procedure
- .02 Revenue Procedure Not Applicable to 403(b) Plans
- .03 Reliance
- .04 Effect of Future Guidance

SECTION 3. GENERALLY APPLICABLE PROVISIONS

- .01 General
- .02 Correction Should not Violate § 401(a)
- .03 Consistency Requirement
- .04 Treatment of Excess Amounts
- .05 No Effect on Other Law
- .06 Definitions
- .07 Assumptions for Examples

SECTION 4. CORRECTION METHODS AND EXAMPLES

- .01 ADP/ACP Failures
- .02 Exclusion of Eligible Employees
 - (1) Exclusion of Eligible Employees in a 401(k) or (m) Plan
 - (2) Exclusion of Eligible Employees in a Profit-Sharing Plan
- .03 Vesting Failures
- .04 § 415 Failures
 - (1) Failures Relating to a § 415(b) Excess
 - (2) Failures Relating to a § 415(c) Excess
- .05 Other Overpayment Failures
- .06 § 401(a)(17) Failures
- .07 Correction by Amendment under Walk-in CAP
 - (1) § 401(a)(17) Failures
 - (2) Hardship Distribution Failures

SECTION 5. EARNINGS ADJUSTMENT METHODS AND EXAMPLES

- .01 Earnings Adjustment Methods
- .02 Examples

SECTION 6. EFFECT ON OTHER DOCUMENTS

SECTION 7. EFFECTIVE DATE

SECTION 8. PAPERWORK REDUCTION ACT

DRAFTING INFORMATION

SECTION 1. PURPOSE AND BACKGROUND

.01 *Purpose.* (1) This revenue procedure augments the Employee Plans Compliance Resolution System ("EPCRS"). It describes and illustrates many of the correction methods sponsors of qualified plans under Internal Revenue Code § 401(a) or 403(a) can use to correct failures to comply with the qualified plan rules. Among the numerous favorable comments on EPCRS, many suggested that it would be helpful to provide additional guidance on acceptable means of correction.

(2) This revenue procedure, together with the standardized correction methods described in Rev. Proc. 98-22, 1998-12 I.R.B. 11, gives plan sponsors methods (and in many cases alternative methods) they can use to correct the Operational Failures typically encountered under EPCRS. Of course, other methods of correcting the same Operational Failures might also be reasonable and appropriate. The methods described in this revenue procedure will be particularly useful for plan sponsors self-correcting Operational Failures under APRSC. The revenue procedure includes numerous examples illustrating these correction methods.

(3) The correction methods described in this revenue procedure include the following --

- For § 401(k) and § 401(m) nondiscrimination failures, in addition to the SVP correction method, a "one-to-one" correction method which combines distribution of excess contributions with an equivalent corrective contribution

that typically will be less than the corrective contribution under the SVP correction method for the same failure;

- If eligible employees have been excluded from receiving employer contributions under a profit-sharing or stock bonus plan, then, in addition to the SVP correction method, improperly allocated contributions can be reallocated to the excluded eligible employees, in accordance with specified requirements;
- If an amount has been improperly forfeited under a defined contribution plan, then either a corrective contribution can be made or, in accordance with specified requirements, the improperly forfeited amount can be reallocated;
- If payments from a defined benefit plan exceeded the § 415(b) limits, the excess can be repaid to the plan or future payments can be reduced;
- If annual additions under a defined contribution plan exceeded the § 415(c) limits, then in addition to the SVP correction method, the previously paid excess can be repaid to the plan or, in the case of certain terminated employees who have received a distribution of elective deferrals, nonvested employer contributions can be forfeited;
- If amounts in excess of certain other limits have been paid, then the excesses can be repaid to the plan or, as an additional alternative in the case of a defined benefit plan, future benefit payments can be reduced;

- If contributions to a defined contribution plan have been allocated based on compensation in excess of the § 401(a)(17) limit, then the excess allocation can be reallocated to other participants or used to reduce future employer contributions or, as an additional alternative, under the Walk-in Closing Agreement Program ("Walk-in CAP"), additional plan contributions can be made for other employees;
- If hardship distributions that were not permitted under plan terms have been made, then, in accordance with specified requirements, a corrective plan amendment can be made under Walk-in CAP; and
- If corrective contributions or allocations are made under a defined contribution plan, several alternative methods are provided for adjustments to reflect earnings.

This revenue procedure also expands the SVP correction method for the exclusion of eligible employees from elective deferrals, employee after-tax contributions, and matching contributions for a full year to include partial year exclusions, and clarifies the SVP correction method for exclusion of eligible employees from employer nonelective contributions under profit-sharing and stock bonus plans.

(4) The Service anticipates that the methods and examples described in this revenue procedure will be updated, and the methods and examples may be supplemented or expanded. In

addition, the Service will continue to monitor and improve EPCRS as a whole, and accordingly, intends to revise Rev. Proc. 98-22 to reflect experience and public comments.

.02 *Background.* (1) Rev. Proc. 98-22, modified and consolidated into EPCRS the various Internal Revenue Service programs relating to correction of certain failures ("Qualification Failures"), which affect the qualification of a plan intended to be qualified under § 401(a) or 403(a) ("Qualified Plans"), or § 403(b) ("403(b) plans"). The programs consolidated into EPCRS include the Administrative Policy Regarding Self-Correction ("APRSC"), the Voluntary Compliance Resolution ("VCR") program, Walk-in CAP, and the Audit Closing Agreement Program ("Audit CAP"). Rev. Proc. 99-13, 1999-5 I.R.B. 52, modified and amplified Rev. Proc. 98-22 with respect to 403(b) plans.

(2) Section 6 of Rev. Proc. 98-22 sets forth correction principles that apply to all of the EPCRS programs. The standardized correction methods permitted under the Standardized VCR Procedure ("SVP") set forth in Appendix A of Rev. Proc. 98-22 are deemed to be reasonable and appropriate methods of correction for certain Qualification Failures that arise solely from failure to follow the terms of a plan ("Operational Failures"). Section 6.02(2) of Rev. Proc. 98-22 provides that there may be more than one reasonable and appropriate correction method for a Qualification Failure. Section 6.02(3) of Rev. Proc. 98-22

provides that corrective allocations under a defined contribution plan should be adjusted for earnings and forfeitures that would have been allocated to a participant's account if the failure had not occurred.

.03 *Overview.* (1) Section 2 of this revenue procedure describes the effect of this revenue procedure and taxpayers' ability to rely on it.

(2) Section 3 sets forth certain provisions that generally apply with respect to the correction methods and earnings adjustment methods under this revenue procedure, and assumptions that apply for purposes of the examples in this revenue procedure.

(3) Section 4 sets forth a number of reasonable and appropriate correction methods (and examples) that may be used to correct specific Operational Failures. Section 4 also clarifies and expands on certain correction methods under SVP. Consistent with section 6.02(2) of Rev. Proc. 98-22, other correction methods, different from those illustrated in this revenue procedure, may also be considered reasonable and appropriate for the same Operational Failure.

(4) Section 5 sets forth earnings adjustment methods (and examples) that may be used to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions

or allocations under the correction methods in section 4 and under certain SVP correction methods. Other earnings adjustment methods, different from those illustrated in this revenue procedure, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

.04 *Request for Comments.* The Service solicits comments and suggestions relating to this revenue procedure. In particular, the Service requests (1) comments on the correction methods, earnings adjustment methods, and examples described in this revenue procedure, (2) suggestions for alternative methods of correction for the Operational Failures addressed in this revenue procedure, and (3) suggestions for methods of correction for Qualification Failures not addressed in this revenue procedure (including methods for correcting failures with respect to 403(b) plans). It is requested that comments and suggestions be submitted by November 21, 1999, addressed to CC:DOM:CORP:R (Rev. Proc. 99-31), Room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. In the alternative, comments may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Rev. Proc. 99-31), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may transmit comments electronically by using the following site:
cynthia.grigsby@ml.irs.counsel.treas.gov

SECTION 2. EFFECT OF THIS REVENUE PROCEDURE; RELIANCE

.01 *Effect of this Revenue Procedure.* If an Operational Failure addressed in this revenue procedure is corrected in the specific manner described in an applicable correction method set forth in this revenue procedure, the Service will treat the correction as a reasonable and appropriate correction for the Operational Failure under section 6.02(2) of Rev. Proc. 98-22. In addition, if an earnings adjustment is made to a corrective contribution or allocation under a defined contribution plan in a specific manner described in section 5 of this revenue procedure, the Service will treat the earnings adjustment as satisfying the requirement of section 6.02(3)(a) of Rev. Proc. 98-22 that corrective allocations in a defined contribution plan be adjusted for earnings.

.02 *Revenue Procedure Not Applicable to 403(b) Plans.* This revenue procedure does not apply to 403(b) plans. Accordingly, sponsors of 403(b) plans cannot rely on the correction methods under section 4 and the earnings adjustment methods under section 5. For guidance relating to 403(b) plans, see Rev. Proc. 99-13.

.03 *Reliance.* Taxpayers may rely on Rev. Proc. 98-22, as supplemented by this revenue procedure. Accordingly, if an Operational Failure addressed in this revenue procedure is corrected in accordance with the requirements of APRSC, VCR, Walk-in CAP, or Audit CAP, whichever is applicable; the eligibility requirements set forth in section 4 of Rev. Proc. 98-

22 for the applicable program are satisfied; and the Operational Failure is corrected using an applicable correction method described in this revenue procedure that otherwise satisfies section 6.02 of Rev. Proc. 98-22, then, in accordance with section 3 of Rev. Proc. 98-22, the plan will not be disqualified by reason of the Operational Failure.

.04 *Effect of Future Guidance.* The Service expects that the correction methods and earnings adjustment methods described in this revenue procedure will be updated periodically in light of experience gained and comments received. However, taxpayers will be able to continue to rely on the correction methods and earnings adjustment methods in this revenue procedure for corrections prior to the publication of future guidance.

SECTION 3. GENERALLY APPLICABLE PROVISIONS

.01 *General.* Unless otherwise specified, the provisions of this section 3 apply for purposes of the correction methods in section 4 and the earnings adjustment methods in section 5 of this revenue procedure.

.02 *Correction Should Not Violate Qualification Requirements.* As provided in Rev. Proc. 98-22, section 6.02(2)(d), the correction method used to correct an Operational Failure should not violate § 401(a). If an additional Qualification Failure is created as a result of the use of a correction method in this revenue procedure, then that Qualification Failure also must be

corrected in conjunction with the use of that correction method and in accordance with the requirements of EPCRS.

.03 *Consistency Requirement.* Generally, where more than one correction method is available to correct a type of Operational Failure for a plan year (or where there are alternative ways to apply a correction method), the correction method (or alternative ways to apply the correction method) should be applied consistently in correcting all Operational Failures of that type for that plan year. Similarly, earnings adjustment methods generally should be applied consistently with respect to corrective contributions or allocations for a particular type of Operational Failure for a plan year.

.04 *Treatment of Excess Amounts.* A distribution of an Excess Amount is not eligible for the favorable tax treatment accorded to distributions from qualified plans (such as eligibility for rollover under § 402(c)). To the extent that a current or prior distribution was a distribution of an Excess Amount, that distribution is not an eligible rollover distribution. Thus, for example, if such a distribution was contributed to an individual retirement arrangement ("IRA"), the contribution is not a valid rollover contribution for purposes of determining the amount of excess contributions (within the meaning of § 4973) to the individual's IRAs. Where an Excess Amount has been distributed in connection with an Operational Failure that is being corrected using a correction method set forth in section 4, the employer

must notify the recipient that (1) the Excess Amount was distributed and (2) the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

.05 *No Effect on Other Law.* In accordance with section 6.06 of Rev. Proc. 98-22, compliance under these programs has no effect on the rights of any party under any other law, including Title I of the Employee Retirement Income Security Act of 1974.

.06 *Definitions.* (1) Definitions from Rev. Proc. 98-22. The definitions set forth in section 5 of Rev. Proc. 98-22 apply for purposes of this revenue procedure.

(2) *Excess Amount Defined.* For purposes of this revenue procedure, an Excess Amount is (a) an Overpayment (within the meaning of section 4.05(2)), (b) an elective deferral or employee after-tax contribution returned to satisfy § 415, (c) an elective deferral in excess of the limitation of § 402(g) that is distributed, (d) an excess contribution or excess aggregate contribution that is distributed to satisfy § 401(k) or § 401(m), or (e) any similar amount required to be distributed in order to maintain plan qualification.

.07 *Assumptions for Examples.* Unless otherwise specified, for ease of presentation, the examples assume that:

(1) the plan year and the § 415 limitation year are the calendar year;

(2) the employer maintains a single plan intended to satisfy § 401(a) and has never maintained any other plan;

(3) in a defined contribution plan, the plan provides that forfeitures are used to reduce future employer contributions;

(4) the Qualification Failures are Operational Failures and the eligibility and other requirements for APRSC, VCR, Walk-in CAP, or Audit CAP, whichever applies, are satisfied; and

(5) there are no Qualification Failures other than the described Operational Failures, and if a corrective action would result in any additional Qualification Failure, appropriate corrective action is taken for that additional Qualification Failure in accordance with EPCRS.

SECTION 4. CORRECTION METHODS AND EXAMPLES

.01 *ADP/ACP Failures*

(1) Correction Methods. (a) SVP Correction Method. Appendix A, section .03 of Rev. Proc. 98-22 sets forth the SVP correction method for a failure to satisfy the actual deferral percentage ("ADP"), actual contribution percentage ("ACP"), or multiple use test set forth in §§ 401(k)(3), 401(m)(2), and 401(m)(9), respectively.

(b) One-to-One Correction Method. (i) General. In addition to the SVP correction method, a failure to satisfy the ADP, ACP, or multiple use test may be corrected using the one-to-one correction method set forth in this section 4.01(1)(b). Under

the one-to-one correction method, an excess contribution amount is determined and assigned to highly compensated employees as provided in paragraph (1)(b)(ii) below. That excess contribution amount (adjusted for earnings) is either distributed to highly compensated employees or forfeited from highly compensated employees' accounts as provided in paragraph (1)(b)(iii) below. That same dollar amount (i.e., the excess contribution amount, adjusted for earnings) is contributed to the plan and allocated to nonhighly compensated employees as provided in paragraph (1)(b)(iv) below.

(ii) Determination of the Excess Contribution Amount. The excess contribution amount for the year is equal to the excess of (A) the sum of the excess contributions (as defined in § 401(k)(8)(B)), the excess aggregate contributions (as defined in § 401(m)(6)(B)), and the amount treated as excess contributions or excess aggregate contributions under the multiple use test pursuant to § 401(m)(9) and § 1.401(m)-2(c) of the Income Tax Regulations for the year, as assigned to each highly compensated employee in accordance with § 401(k)(8)(C) and (m)(6)(C), over (B) previous corrections permitted under § 401(k)(8), (m)(6), and (m)(9). See Notice 97-2, 1997-1 C.B. 348.

(iii) Distributions and Forfeitures of the Excess Contribution Amount. (A) The portion of the excess contribution amount assigned to a particular highly compensated employee under paragraph (1)(b)(ii) is adjusted for earnings through the date of

correction. The amount assigned to a particular highly compensated employee, as adjusted, is distributed or, to the extent the amount is forfeitable as of the close of the plan year of the failure, is forfeited. If the amount is forfeited, it is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure. If the amount so assigned to a particular highly compensated employee has been previously distributed, the amount is an Excess Amount within the meaning of section 3.06(2). Thus, pursuant to section 3.04, the employer must notify the employee that the Excess Amount was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(B) If any matching contributions (adjusted for earnings) are forfeited in accordance with § 411(a)(3)(G), the forfeited amount is used in accordance with the plan provisions relating to forfeitures that were in effect for the year of the failure.

(C) If a payment was made to an employee and that payment is a forfeitable match described in either paragraph 4.01(b)(iii) (A) or (B), then it is an Overpayment defined in section 4.05(2) that must be corrected (see section 4.05(1)).

(iv) Contribution and Allocation of Equivalent Amount. (A) The employer makes a contribution to the plan that is equal to the aggregate amounts distributed and forfeited under paragraph (1)(b)(iii)(A) (i.e., the excess contribution amount adjusted for

earnings, as provided in paragraph (1)(b)(iii)(A), which does not include any matching contributions forfeited in accordance with § 411(a)(3)(G) as provided in paragraph (1)(b)(iii)(B)). The contribution must satisfy the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B)(1) This paragraph (1)(b)(iv)(B)(1) applies to a plan that uses the current year testing method described in Notice 98-1, 1998-3 I.R.B. 42. The contribution made under paragraph (1)(b)(iv)(A) is allocated to the account balances of those individuals who were either (I) the eligible employees for the year of the failure who were not highly compensated employees for that year or (II) the eligible employees for the year of the failure who were not highly compensated employees for that year and who also are not highly compensated employees for the year of correction. Alternatively, the contribution is allocated to account balances of eligible employees described in (I) or (II) of the preceding sentence, except that the allocation is made only to the account balances of those employees who are employees on a date during the year of the correction that is no later than the date of correction. Regardless of which of these four options (described in the two preceding sentences) the employer selects, the contribution is allocated to each such employee either as the same percentage of the employee's compensation for the year of the failure or as the same dollar amount for each employee. (See Examples 1, 2 and 3.) Under the one-to-one

correction method, the amount allocated to the account balance of an employee (i.e, the employee's share of the total amount contributed under paragraph (1)(b)(iv)(A)) is not further adjusted for earnings and is treated as an annual addition under § 415 for the year of the failure for the employee for whom it is allocated.

(2) This paragraph (1)(b)(iv)(B)(2) applies to a plan that uses the prior year testing method described in Notice 98-1. Paragraph (1)(b)(iv)(B)(1) is applied by substituting "the year prior to the year of the failure" for "the year of the failure".

(2) Examples.

Example 1:

Employer A maintains a profit-sharing plan with a cash or deferred arrangement that is intended to satisfy § 401(k) ("401(k) plan") using the current year testing method described in Notice 98-1. The plan does not provide for matching contributions or employee after-tax contributions. In 1999, it was discovered that the ADP test for 1997 was not performed correctly. When the ADP test was performed correctly, the test was not satisfied for 1997. For 1997, the ADP for highly compensated employees was 9% and the ADP for nonhighly compensated employees was 4%. Accordingly, the ADP for highly compensated employees exceeded the ADP for nonhighly compensated employees by more than two percentage points (in violation of § 401(k)(3)). (The ADP

for nonhighly compensated employees for 1996 also was 4%, so the ADP test for 1997 would not have been satisfied even if the plan had used the prior year testing method described in Notice 98-1.) There were two highly compensated employees eligible under the 401(k) plan during 1997, Employee P and Employee Q. Employee P made elective deferrals of \$8,000, which is equal to 10% of Employee P's compensation of \$80,000 for 1997. Employee Q made elective deferrals of \$9,500, which is equal to 8% of Employee Q's compensation of \$118,750 for 1997.

Correction:

On June 30, 1999, Employer A uses the one-to-one correction method to correct the failure to satisfy the ADP test for 1997. Accordingly, Employer A calculates the dollar amount of the excess contributions for the two highly compensated employees in the manner described in § 401(k)(8)(B). The amount of the excess contribution for Employee P is \$3,200 (4% of \$80,000) and the amount of the excess contribution for Employee Q is \$2,375 (2% of \$118,750), or a total of \$5,575. In accordance with § 401(k)(8)(C), \$5,575, the excess contribution amount, is assigned \$2,037.50 to Employee P and \$3,537.50 to Employee Q. It is determined that the earnings on the assigned amounts through June 30, 1999 are \$407 and \$707 for Employees P and Q, respectively. The assigned amounts and the earnings are distributed to

Employees P and Q. Therefore, Employee P receives \$2,444.50 (\$2,037.50 + \$407) and Employee Q receives \$4,244.50 (\$3,537.50 + \$707). In addition, on the same date, a corrective contribution is made to the 401(k) plan equal to \$6,689 (the sum of the \$2,444.50 distributed to Employee P and the \$4,244.50 distributed to Employee Q). The corrective contribution is allocated to the account balances of eligible nonhighly compensated employees for 1997, pro rata based on their compensation for 1997 (subject to § 415 for 1997).

Example 2:

The facts are the same as in Example 1.

Correction:

The correction is the same as in Example 1, except that the corrective contribution of \$6,689 is allocated in an equal dollar amount to the account balances of eligible nonhighly compensated employees for 1997 who are employees on June 30, 1999 and who are nonhighly compensated employees for 1999 (subject to § 415 for 1997).

Example 3:

The facts are the same as in Example 1, except that for 1997 the plan also provides (1) for employee after-tax contributions and (2) for matching contributions equal to 50% of the sum of an employee's elective deferrals and employee after-tax contributions that do not exceed 10% of

the employee's compensation. The plan provides that matching contributions are subject to the plan's 5-year graded vesting schedule and that matching contributions are forfeited and used to reduce employer contributions if associated elective deferrals or employee after-tax contributions are distributed to correct an ADP, ACP or multiple use test failure. For 1997, nonhighly compensated employees made employee after-tax contributions and no highly compensated employee made any employee after-tax contributions. Employee P received a matching contribution of \$4,000 (50% of \$8,000) and Employee Q received a matching contribution of \$4,750 (50% of \$9,500). Employees P and Q were 100% vested in 1997. It is determined that, for 1997, the ACP for highly compensated employees was not more than 125% of the ACP for nonhighly compensated employees, so that the ACP and multiple use tests would have been satisfied for 1997 without any corrective action.

Correction:

The same corrective actions are taken as in Example 1. In addition, in accordance with the plan's terms, corrective action is taken to forfeit Employee P's and Employee Q's matching contributions associated with their distributed excess contributions. Employee P's distributed excess contributions and associated matching contributions are \$2,037.50 and \$1,018.75, respectively. Employee Q's

distributed excess contributions and associated matching contributions are \$3,537.50 and \$1,768.75, respectively. Thus, \$1,018.75 is forfeited from Employee P's account and \$1,768.75 is forfeited from Employee Q's account. In addition, the earnings on the forfeited amounts are also forfeited. It is determined that the respective earnings on the forfeited amount for Employee P is \$150 and for Employee Q is \$204. The total amount of the forfeitures of \$3,141.50 (Employee P's \$1,018.75 + \$150 and Employee Q's \$1,768.75 + \$204) is used to reduce contributions for 1999 and subsequent years.

.02 Exclusion of Eligible Employees

(1) Exclusion of Eligible Employees in a 401(k) or (m) Plan.

(a) Correction Method. (i) SVP Correction Method for Full Year Exclusion. Appendix A, section .05 of Rev. Proc. 98-22 sets forth the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for one or more full plan years. (See Example 4.) In section 4.02(1)(a)(ii) below, the SVP correction method for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a full year is expanded to include correction for the exclusion of an eligible employee from all contributions under a 401(k) or (m) plan for a partial plan year. This correction for a partial year exclusion may be used in conjunction with the correction for a full year exclusion.

(ii) Expansion of SVP Correction Method to Partial Year Exclusion. (A) In General. The correction method in Appendix A, section .05 of Rev. Proc. 98-22 is expanded to cover an employee who was improperly excluded from making elective deferrals or employee after-tax contributions for a portion of a plan year or from receiving matching contributions (on either elective deferrals or employee after-tax contributions) for a portion of a plan year. In such case, the permitted correction method under SVP for the failure is for the employer to satisfy this section 4.02(1)(a)(ii). The employer makes a corrective contribution on behalf of the excluded employee that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C).

(B) Elective Deferral Failures. The appropriate corrective contribution for the failure to allow employees to make elective deferrals for a portion of the plan year is equal to the ADP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 4.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution for the portion of the plan year during which the employee was improperly excluded from being eligible to make elective deferrals is reduced to the extent that (1) the sum of that contribution and any elective deferrals actually made by the employee for that year would exceed (2) the maximum elective

deferrals permitted under the plan for the employee for that plan year (including the § 402(g) limit). The corrective contribution is adjusted for earnings. (See Examples 5 and 6.)

(C) Employee After-tax and Matching Contribution Failures. The appropriate corrective contribution for the failure to allow employees to make employee after-tax contributions or to receive matching contributions because the employee was precluded from making employee after-tax contributions or elective deferrals for a portion of the plan year is equal to the ACP of the employee's group (either highly or nonhighly compensated), determined prior to correction under this section 4.02(1)(a)(ii), multiplied by the employee's plan compensation for the portion of the year during which the employee was improperly excluded. The corrective contribution is reduced to the extent that (1) the sum of that contribution and the actual total employee after-tax and matching contributions made by and for the employee for the plan year would exceed (2) the sum of the maximum employee after-tax contributions permitted under the plan for the employee for the plan year and the matching contributions that would have been made if the employee had made the maximum matchable contributions permitted under the plan for the employee for that plan year. The corrective contribution is adjusted for earnings.

(D) Use of Prorated Compensation. For purposes of this paragraph (1)(a)(ii), for administrative convenience, in lieu of using the employee's actual plan compensation for the portion of

the year during which the employee was improperly excluded, a pro rata portion of the employee's plan compensation that would have been taken into account for the plan year, if the employee had not been improperly excluded, may be used.

(E) Special Rule for Brief Exclusion from Elective Deferrals. An employer is not required to make a corrective contribution with respect to elective deferrals, as provided in section 4.02(1)(a)(ii)(B), (but is required to make a corrective contribution with respect to any employee after-tax and matching contributions, as provided in section 4.02(1)(a)(ii)(C)) for an employee for a plan year if the employee has been provided the opportunity to make elective deferrals under the plan for a period of at least the last 9 months in that plan year and during that period the employee had the opportunity to make elective deferrals in an amount not less than the maximum amount that would have been permitted if no failure had occurred. (See Example 7.)

(b) Examples.

Example 4:

Employer B maintains a 401(k) plan. The plan provides for matching contributions for eligible employees equal to 100% of elective deferrals that do not exceed 3% of an employee's compensation. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. Twelve

employees (8 nonhighly compensated employees and 4 highly compensated employees) who had met the one year eligibility requirement after July 1, 1995 and before January 1, 1996 were inadvertently excluded from participating in the plan beginning on January 1, 1996. These employees were offered the opportunity to begin participating in the plan on January 1, 1997. For 1996, the ADP for the highly compensated employees was 8% and the ADP for the nonhighly compensated employees was 6%. In addition, for 1996, the ACP for the highly compensated employees was 2.5% and the ACP for the nonhighly compensated employees was 2%. The failure to include the 12 employees was discovered during 1998.

Correction:

Employer B uses the SVP correction method for full year exclusions to correct the failure to include the 12 eligible employees in the plan for the full plan year beginning January 1, 1996. Thus, Employer B makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for each of the excluded employees. The contribution for each of the improperly excluded highly compensated employees is 10.5% (the highly compensated employees' ADP of 8% plus ACP of 2.5%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings). The contribution for each of

the improperly excluded nonhighly compensated employees is 8% (the nonhighly compensated employee's ADP of 6% plus ACP of 2%) of the employee's plan compensation for the 1996 plan year (adjusted for earnings).

Example 5:

Employer C maintains a 401(k) plan. The plan provides for matching contributions for each payroll period that are equal to 100% of an employee's elective deferrals that do not exceed 2% of the eligible employee's plan compensation during the payroll period. The plan does not provide for employee after-tax contributions. The plan provides that employees who complete one year of service are eligible to participate in the plan on the next January 1 or July 1 entry date. A nonhighly compensated employee who met the eligibility requirements and should have entered the plan on January 1, 1996 was not offered the opportunity to participate in the plan. In August of 1996, the error was discovered and Employer C offered the employee an election opportunity as of September 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 (resulting in elective deferrals of \$500). The employee's plan compensation for 1996 was \$36,000 (\$23,500 for the first eight months and \$12,500 for the last four months). Employer C made matching

contributions equal to \$250 for the excluded employee, which is 2% of the employee's plan compensation for each payroll period from September 1, 1996 through December 31, 1996 (\$12,500). The ADP for nonhighly compensated employees for 1996 was 3% and the ACP for nonhighly compensated employees for 1996 was 1.8%.

Correction:

Employer C uses the SVP correction method for partial year exclusions to correct the failure to include the eligible employee in the plan. Thus, Employer C makes a corrective contribution (that satisfies the vesting requirements and distribution limitations of § 401(k)(2)(B) and (C)) for the excluded employee. In determining the amount of corrective contributions (both for the elective deferral and for the matching contribution), for administrative convenience, in lieu of using actual plan compensation of \$23,500 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the eight-month period that the employee was excluded from participating in the plan. The failure to provide the excluded employee the right to make elective deferrals is corrected by the employer making a corrective contribution on behalf of the employee that is equal to \$720 (the 3% ADP percentage for nonhighly compensated employees multiplied by \$24,000, which is 8/12ths of the employee's 1996 plan compensation of

\$36,000), adjusted for earnings. In addition, to correct for the failure to receive the plan's matching contribution, a corrective contribution is made on behalf of the employee that is equal to \$432 (the 1.8% ACP for the nonhighly compensated group multiplied by \$24,000, which is 8/12ths of the employee's 1996 plan compensation of \$36,000), adjusted for earnings. Employer C determines that \$682, the sum of the actual matching contribution received by the employee for the plan year (\$250) and the corrective contribution to correct the matching contribution failure (\$432), does not exceed \$720, the maximum matching contribution available to the employee under the plan (2% of \$36,000) determined as if the employee had made the maximum matchable contributions. In addition to correcting the failure to include the eligible employee in the plan, Employer C reruns the ADP and ACP tests for 1996 (taking into account the corrective contribution and plan compensation for 1996 for the excluded employee) and determines that the tests were satisfied.

Example 6:

The facts are the same as in Example 5, except that the plan provides for matching contributions that are equal to 100% of an eligible employee's elective deferrals that do not exceed 2% of the employee's plan compensation for the plan year. Accordingly, the actual matching contribution made by Employer C for the excluded employee for the last four

months of 1996 is \$500 (which is equal to 100% of the \$500 of elective deferrals made by the employee for the last four months of 1996).

Correction:

The correction is the same as in Example 5, except that the corrective contribution made for the first 8 months of 1996 to correct the failure to make matching contributions is equal to \$220 (adjusted for earnings), instead of the \$432 (adjusted for earnings) in Example 5, because the corrective contribution is limited to the maximum matching contributions available under the plan for the employee for the plan year, \$720 (2% of \$36,000), reduced by the actual matching contributions made for the employee for the plan year, \$500.

Example 7:

The facts are the same as in Example 5, except that the error is discovered in March of 1996 and the employee was given the opportunity to make elective deferrals beginning on April 1, 1996. The amount of elective deferrals that the employee was given the opportunity to make during 1996 was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996. The employee made elective deferrals equal to 4% of the employee's plan compensation for each payroll period

from April 1, 1996 through December 31, 1996 of \$28,000 (resulting in elective deferrals of \$1,120). Employer C made a matching contribution equal to \$560, which is 2% of the employee's plan compensation for each payroll period from April 1, 1996 through December 31, 1996 (\$28,000). The employee's plan compensation for 1996 was \$36,000 (\$8,000 for the first three months and \$28,000 for the last nine months).

Correction:

Employer C uses the SVP correction method for partial year exclusions to correct the failure to include an eligible employee in the plan. Because the employee was given an opportunity to make elective deferrals to the plan for at least the last 9 months of the plan year (and the amount of the elective deferrals that the employee had the opportunity to make was not less than the maximum elective deferrals that the employee could have made if the employee had been given the opportunity to make elective deferrals beginning on January 1, 1996), under the special rule set forth in section 4.02(1)(a)(ii)(E), Employer C is not required to make a corrective contribution for the failure to allow the employee to make elective deferrals. In determining the amount of corrective contribution with respect to the failure to allow the employee to receive matching contributions, in lieu of using actual plan compensation of

\$8,000 for the period the employee was excluded, the employee's annual plan compensation is pro rated for the three-month period that the employee was excluded from participating in the plan. Accordingly, a corrective contribution is made on behalf of the employee that is equal to \$160, which is the lesser of (i) \$162 (a matching contribution of 1.8% of \$9,000, which is 3/12ths of the employee's 1996 plan compensation of \$36,000), and (ii) \$160 (the excess of the maximum matching contribution for the entire plan year, which is equal to 2% of \$36,000, or \$720, over the matching contributions made after March 31, 1996, \$560). The contribution is adjusted for earnings.

(2) Exclusion of Eligible Employees In a Profit-Sharing Plan.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .05 of Rev. Proc. 98-22 sets forth the SVP correction method for correcting the exclusion of an eligible employee. In the case of a defined contribution plan, the SVP correction method is to make a contribution on behalf of the excluded employee. Section 4.02(2)(a)(ii) below clarifies the SVP correction method in the case of a profit-sharing or stock bonus plan that provides for nonelective contributions (within the meaning of § 1.401(k)-1(g)(10)).

(ii) Clarification of SVP Correction Method for Profit-Sharing Plans. To correct for the exclusion of an eligible employee from nonelective contributions in a profit-sharing or stock bonus plan

under the SVP correction method, an allocation amount is determined for each excluded employee on the same basis as the allocation amounts were determined for the other employees under the plan's allocation formula (e.g., the same ratio of allocation to compensation), taking into account all of the employee's relevant factors (e.g., compensation) under that formula for that year. The employer makes a corrective contribution on behalf of the excluded employee that is equal to the allocation amount for the excluded employee. The corrective contribution is adjusted for earnings. If, as a result of excluding an employee, an amount was improperly allocated to the account balance of an eligible employee who shared in the original allocation of the nonelective contribution, no reduction is made to the account balance of the employee who shared in the original allocation on account of the improper allocation. (See Example 8.)

(iii) Reallocation Correction Method. (A) In General. Subject to the limitations set forth in section 4.02(2)(a)(iii)(F) below, in addition to the SVP correction method, the exclusion of an eligible employee for a plan year from a profit-sharing or stock bonus plan that provides for nonelective contributions may be corrected using the reallocation correction method set forth in this section 4.02(2)(a)(iii). Under the reallocation correction method, the account balance of the excluded employee is increased as provided in paragraph (2)(a)(iii)(B) below, the account balances of other employees are reduced as provided in paragraph

(2)(a)(iii)(C) below, and the increases and reductions are reconciled, as necessary, as provided in paragraph (2)(a)(iii)(D) below. (See Examples 9 and 10.)

(B) Increase in Account Balance of Excluded Employee. The account balance of the excluded employee is increased by an amount that is equal to the allocation the employee would have received had the employee shared in the allocation of the nonelective contribution. The amount is adjusted for earnings.

(C) Reduction in Account Balances of Other Employees. (1) The account balance of each employee who was an eligible employee who shared in the original allocation of the nonelective contribution is reduced by the excess, if any, of (I) the employee's allocation of that contribution over (II) the amount that would have been allocated to that employee had the failure not occurred. This amount is adjusted for earnings taking into account the rules set forth in section 4.02(2)(a)(iii)(C)(2) and (3) below. The amount after adjustment for earnings is limited in accordance with section 4.02(2)(a)(iii)(C)(4) below.

(2) This paragraph (2)(a)(iii)(C)(2) applies if most of the employees with account balances that are being reduced are nonhighly compensated employees. If there has been an overall gain for the period from the date of the original allocation of the contribution through the date of correction, no adjustment for earnings is required to the amount determined under section 4.02(2)(a)(iii)(C)(1) for the employee. If the amount for the

employee is being adjusted for earnings and the plan permits investment of account balances in more than one investment fund, for administrative convenience, the reduction to the employee's account balance may be adjusted by the lowest earnings rate of any fund for the period from the date of the original allocation of the contribution through the date of correction.

(3) If an employee's account balance is reduced and the original allocation was made to more than one investment fund or there was a subsequent distribution or transfer from the fund receiving the original allocation, then, reasonable, consistent assumptions are used to determine the earnings adjustment.

(4) The amount determined in section 4.02(2)(a)(iii)(C)(1) for an employee after the application of section 4.02(2)(a)(iii)(C)(2) and (3) may not exceed the account balance of the employee on the date of correction, and the employee is permitted to retain any distribution made prior to the date of correction.

(D) Reconciliation of Increases and Reductions. If the aggregate amount of the increases under section 4.02(2)(a)(iii)(B) exceeds the aggregate amount of the reductions under section 4.02(2)(a)(iii)(C), the employer makes a corrective contribution to the plan for the amount of the excess. If the aggregate amount of the reductions under section 4.02(2)(a)(iii)(C) exceeds the aggregate amount of the increases under section 4.02(2)(a)(iii)(B), then the amount by which each

employee's account balance is reduced under section 4.02(2)(A)(iii)(C) is decreased on a pro rata basis.

(E) Reductions Among Multiple Investment Funds. If an employee's account balance is reduced and the employee's account balance is invested in more than one investment fund, then the reduction may be made from the investment funds selected in any reasonable manner.

(F) Limitations on Use of Reallocation Correction Method. If any employee would be permitted to retain any distribution pursuant to section 4.02(2)(a)(iii)(C)(4), then the reallocation correction method may not be used unless most of the employees who would be permitted to retain a distribution are nonhighly compensated employees.

(b) Examples.

Example 8:

Employer D maintains a profit-sharing plan that provides for discretionary nonelective employer contributions. The plan provides that the employer's contributions are allocated to account balances in the ratio that each eligible employee's compensation for the plan year bears to the compensation of all eligible employees for the plan year and, therefore, the only relevant factor for determining an allocation is the employee's compensation. The plan provides for self-directed investments among four investment funds and daily valuations of account balances. For the 1997 plan year,

Employer D made a contribution to the plan of a fixed dollar amount. However, five employees who met the eligibility requirements were inadvertently excluded from participating in the plan. The contribution resulted in an allocation on behalf of each of the eligible employees, other than the excluded employees, equal to 10% of compensation. Most of the employees who received allocations under the plan for the year of the failure were nonhighly compensated employees. No distributions have been made from the plan since 1997. If the five excluded employees had shared in the original allocation, the allocation made on behalf of each employee would have equaled 9% of compensation. The excluded employees began participating in the plan in the 1998 plan year.

Correction:

Employer D uses the SVP correction method to correct the failure to include the five eligible employees. Thus, Employer D makes a corrective contribution to the plan. The amount of the corrective contribution on behalf of the five excluded employees for the 1997 plan year is equal to 10% of compensation of each excluded employee, the same allocation that was made for other eligible employees, adjusted for earnings. The excluded employees receive an allocation equal to 10% of compensation (adjusted for earnings) even though, had the excluded employees originally shared in the

allocation for the 1997 contribution, their account balances, as well as those of the other eligible employees, would have received an allocation equal to only 9% of compensation.

Example 9:

The facts are the same as in Example 8.

Correction:

Employer D uses the reallocation correction method to correct the failure to include the five eligible employees.

Thus, the account balances are adjusted to reflect what

would have resulted from the correct allocation of the

employer contribution for the 1997 plan year among all eligible employees, including the five excluded employees.

The inclusion of the excluded employees in the allocation of that contribution would have resulted in each eligible

employee, including each excluded employee, receiving an

allocation equal to 9% of compensation. Accordingly, the

account balance of each excluded employee is increased by 9%

of the employee's 1997 compensation, adjusted for earnings.

The account balance of each of the eligible employees other

than the excluded employees is reduced by 1% of the

employee's 1997 compensation, adjusted for earnings.

Employer D determines the adjustment for earnings using the

earnings rate of each eligible employee's excess allocation

(using reasonable, consistent assumptions). Accordingly,

for an employee who shared in the original allocation and directed the investment of the allocation into more than one investment fund or who subsequently transferred a portion of a fund that had been credited with a portion of the 1997 allocation to another fund, reasonable, consistent assumptions are followed to determine the adjustment for earnings. It is determined that the total of the initially determined reductions in account balances exceeds the total of the required increases in account balances. Accordingly, these initially determined reductions are decreased pro rata so that the total of the actual reductions in account balances equals the total of the increases in the account balances, and Employer D does not make any corrective contribution. The reduction from the account balances are made on a pro rata basis among all of the funds in which each employee's account balance is invested.

Example 10:

The facts are the same as in Example 8.

Correction:

The correction is the same as in Example 9, except that, because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer D uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each

account balance. It is determined that the aggregate amount (adjusted for earnings) by which the account balances of the excluded employees is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer D makes a contribution to the plan in an amount equal to the excess. The reduction from account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.03 *Vesting Failures*

(1) Correction Methods. (a) Contribution Correction Method.

A failure in a defined contribution plan to apply the proper vesting percentage to an employee's account balance that results in forfeiture of too large a portion of the employee's account balance may be corrected using the contribution correction method set forth in this paragraph. The employer makes a corrective contribution on behalf of the employee whose account balance was improperly forfeited in an amount equal to the improper forfeiture. The corrective contribution is adjusted for earnings. If, as a result of the improper forfeiture, an amount was improperly allocated to the account balance of another employee, no reduction is made to the account balance of that employee. (See Example 11.)

(b) Reallocation Correction Method. In addition to the contribution correction method, in a defined contribution plan

under which forfeitures of account balances are reallocated among the account balances of the other eligible employees in the plan, a failure to apply the proper vesting percentage to an employee's account balance which results in forfeiture of too large a portion of the employee's account balance may be corrected under the reallocation correction method set forth in this paragraph. A corrective reallocation is made in accordance with the reallocation correction method set forth in section 4.02(2)(a)(iii), subject to the limitations set forth in section 4.02(2)(a)(iii)(F). In applying section 4.02(2)(a)(iii)(B), the account balance of the employee who incurred the improper forfeiture is increased by an amount equal to the amount of the improper forfeiture and the amount is adjusted for earnings. In applying section 4.02(2)(a)(iii)(C)(1), the account balance of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account. The earnings adjustments for the account balances that are being reduced are determined in accordance with sections 4.02(2)(a)(iii)(C)(2) and (3) and the reductions after adjustments for earnings are limited in accordance with section 4.02(2)(a)(iii)(C)(4). In accordance with section 4.02(2)(a)(iii)(D), if the aggregate amount of the increases exceeds the aggregate amount of the reductions, the employer makes a corrective contribution to the plan for the amount of the excess. In accordance with section

4.02(2)(a)(iii)(D), if the aggregate amount of the reductions exceeds the aggregate amount of the increases, then the amount by which each employee's account balance is reduced is decreased on a pro rata basis. (See Example 12.)

(2) Examples.

Example 11:

Employer E maintains a profit-sharing plan that provides for nonelective contributions. The plan provides for self-directed investments among four investment funds and daily valuation of account balances. The plan provides that forfeitures of account balances are reallocated among the account balances of other eligible employees on the basis of compensation. During the 1997 plan year, Employee R terminated employment with Employer E and elected and received a single-sum distribution of the vested portion of his account balance. No other distributions have been made since 1997. However, an incorrect determination of Employee R's vested percentage was made resulting in Employee R receiving a distribution of less than the amount to which he was entitled under the plan. The remaining portion of Employee R's account balance was forfeited and reallocated (and these reallocations were not affected by the limitations of § 415). Most of the employees who received allocations of the improper forfeiture were nonhighly compensated employees.

Correction:

Employer E uses the contribution correction method to correct the improper forfeiture. Thus, Employer E makes a contribution on behalf of Employee R equal to the incorrectly forfeited amount (adjusted for earnings) and Employee R's account balance is increased accordingly. No reduction is made from the account balances of the employees who received an allocation of the improper forfeiture.

Example 12:

The facts are the same as in Example 11.

Correction:

Employer E uses the reallocation correction method to correct the improper forfeiture. Thus, Employee R's account balance is increased by the amount that was improperly forfeited (adjusted for earnings). The account of each employee who shared in the allocation of the improper forfeiture is reduced by the amount of the improper forfeiture that was allocated to that employee's account (adjusted for earnings). Because most of the employees whose account balances are being reduced are nonhighly compensated employees, for administrative convenience, Employer E uses the earnings rate of the fund with the lowest earnings rate for the period of the failure to adjust the reduction to each account balance. It is determined that the amount (adjusted for earnings) by which the account

balance of Employee R is increased exceeds the aggregate amount (adjusted for earnings) by which the other employees' account balances are reduced. Accordingly, Employer E makes a contribution to the plan in an amount equal to the excess. The reduction from the account balances is made on a pro rata basis among all of the funds in which each employee's account balance is invested.

.04 § 415 Failures

(1) Failures Relating to a § 415(b) Excess.

(a) Correction Methods. (i) Return of Overpayment Correction Method. Overpayments as a result of amounts being paid in excess of the limits of § 415(b) may be corrected using the return of overpayment correction method set forth in this paragraph (1)(a)(i). The employer takes reasonable steps to have the Overpayment (with appropriate interest) returned by the recipient to the plan and reduces future benefit payments (if any) due to the employee to reflect § 415(b). To the extent the amount returned by the recipient is less than the Overpayment, adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. In addition, in accordance with section 3.04, the employer must notify the recipient that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). (See Examples 15 and 16.)

(ii) Adjustment of Future Payments Correction Method. (A) In General. In addition to the return of overpayment correction method, in the case of plan benefits that are being distributed in the form of periodic payments, Overpayments as a result of amounts being paid in excess of the limits in § 415(b) may be corrected by using the adjustment of future payments correction method set forth in this paragraph (1)(a)(ii). Future payments to the recipient are reduced so that they do not exceed the § 415(b) maximum limit and an additional reduction is made to recoup the Overpayment (over a period not longer than the remaining payment period) so that the actuarial present value of the additional reduction is equal to the Overpayment plus interest at the interest rate used by the plan to determine actuarial equivalence. (See Examples 13 and 14.)

(B) Joint and Survivor Annuity Payments. If the employee is receiving payments in the form of a joint and survivor annuity, with the employee's spouse to receive a life annuity upon the employee's death equal to a percentage (e.g., 75%) of the amount being paid to the employee, the reduction of future annuity payments to reflect § 415(b) reduces the amount of benefits payable during the lives of both the employee and spouse, but any reduction to recoup Overpayments made to the employee does not reduce the amount of the spouse's survivor benefit. Thus, the spouse's benefit will be based on the previous specified percentage (e.g., 75%) of the maximum permitted under § 415(b),

instead of the reduced annual periodic amount payable to the employee.

(C) Overpayment Not Treated as an Excess Amount. An Overpayment corrected under this adjustment of future payment correction method, is not treated as an Excess Amount as defined in section 3.06(2).

(b) Examples.

Example 13:

Employer F maintains a defined benefit plan funded solely through employer contributions. The plan provides that the benefits of employees are limited to the maximum amount permitted under § 415(b), disregarding cost-of-living adjustments under § 415(d) after benefit payments have commenced. At the beginning of the 1998 plan year, Employee S retired and started receiving an annual straight life annuity of \$140,000 from the plan. Due to an administrative error, the annual amount received by Employee S for 1998 included an Overpayment of \$10,000 (because the § 415(b)(1)(A) limit for 1998 was \$130,000). This error was discovered at the beginning of 1999.

Correction:

Employer F uses the adjustment of future payments correction method to correct the failure to satisfy the limit in § 415(b). Future annuity benefit payments to Employee S are reduced so that they do not exceed the § 415(b) maximum

limit, and, in addition, Employee S's future benefit payments from the plan are actuarially reduced to recoup the Overpayment. Accordingly, Employee S's future benefit payments from the plan are reduced to \$130,000 and further reduced by \$1,000 annually for life, beginning in 1999. The annual benefit amount is reduced by \$1,000 annually for life because, for Employee S, the actuarial present value of a benefit of \$1,000 annually for life commencing in 1999 is equal to the sum of \$10,000 and interest at the rate used by the plan to determine actuarial equivalence beginning with the date of the first Overpayment and ending with the date the reduced annuity payment begins. Thus, Employee S's remaining benefit payments are reduced so that Employee S receives \$129,000 for 1999, and for each year thereafter.

Example 14:

The facts are the same as in Example 13.

Correction:

Employer F uses the adjustments of future payments correction method to correct the § 415(b) failure, by recouping the entire excess payment made in 1998 from Employee S's remaining benefit payments for 1999. Thus, Employee S's annual annuity benefit for 1999 is reduced to \$119,400 to reflect the excess benefit amounts (increased by interest) that were paid from the plan to Employee S during the 1998 plan year. Beginning in 2000, Employee S begins to

receive annual benefit payments of \$130,000.

Example 15:

The facts are the same as in Example 13, except that the benefit was paid to Employee S in the form of a single-sum distribution in 1998, which exceeded the maximum § 415(b) limits by \$110,000.

Correction:

Employer F uses the return of overpayment correction method to correct the § 415 (b) failure. Thus, Employer F notifies Employee S of the \$110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. Employee S pays the \$110,000 (plus the requested interest) to the plan. It is determined that the plan's earnings rate for the relevant period was 2 percentage points more than the rate used by the plan to calculate the single-sum payment. Accordingly, Employer F contributes the difference to the plan.

Example 16:

The facts are the same as in Example 15.

Correction:

Employer F uses the return of overpayment correction method to correct the § 415(b) failure. Thus, Employer F notifies Employee S of the \$110,000 Overpayment and that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover). The notice also informs Employee S that the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) is owed to the plan. Employer F takes reasonable steps to have the Overpayment (with interest at the rate used by the plan to calculate the single-sum payment) paid to the plan. As a result of Employer F's recovery efforts, some, but not all, of the Overpayment (with interest) is recovered from Employee S. It is determined that the amount returned by Employee S to the plan is less than the Overpayment adjusted for earnings at the plan's earnings rate. Accordingly, Employer F contributes the difference to the plan.

(2) Failures Relating to a § 415(c) Excess.

(a) Correction Methods. (i) SVP Correction Method. Appendix A, section .08 of Rev. Proc. 98-22 sets forth the SVP correction method for correcting the failure to satisfy the § 415(c) limits on annual additions.

(ii) Forfeiture Correction Method. In addition to the SVP correction method, the failure to satisfy § 415(c) with respect to a nonhighly compensated employee (A) who in the limitation year of the failure had annual additions consisting of both (I) either elective deferrals or employee after-tax contributions and (II) either matching or nonelective contributions, (B) for whom the matching and nonelective contributions equal or exceed the portion of the employee's annual addition that exceeds the limits under § 415(c) ("§ 415(c) excess") for the limitation year, and (C) who has terminated with no vested interest in the matching and nonelective contributions (and has not been reemployed at the time of the correction), may be corrected by using the forfeiture correction method set forth in this paragraph. The § 415(c) excess is deemed to consist solely of the matching and nonelective contributions. If the employee's § 415(c) excess (adjusted for earnings) has previously been forfeited, the § 415(c) failure is deemed to be corrected. If the § 415(c) excess (adjusted for earnings) has not been forfeited, that amount is placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is reallocated to the other employees in accordance with the plan's allocation formula). Note that while this correction

method will permit more favorable tax treatment of elective deferrals for the employee than the SVP correction method, this correction method could be less favorable to the employee in certain cases, for example, if the employee is subsequently reemployed and becomes vested. (See Examples 17 and 18.)

(iii) Return of Overpayment Correction Method. A failure to satisfy § 415(c) that includes a distribution of the § 415(c) excess attributable to nonelective contributions and matching contributions may be corrected using the return of overpayment correction method set forth in this paragraph. The employer takes reasonable steps to have the Overpayment (i.e., the distribution of the 415(c) excess adjusted for earnings to the date of the distribution), plus appropriate interest from the date of the distribution to the date of the repayment, returned by the employee to the plan. To the extent the amount returned by the employee is less than the Overpayment adjusted for earnings at the plan's earnings rate, then the employer or another person contributes the difference to the plan. The Overpayment, adjusted for earnings at the plan's earnings rate to the date of the repayment, is to be placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s) (or if the amount would have been allocated to other eligible employees who were in the plan for the year of the failure if the failure had not occurred, then that amount is

reallocated to the other eligible employees in accordance with the plan's allocation formula). In addition, the employer must notify the employee that the Overpayment was not eligible for favorable tax treatment accorded to distributions from qualified plans (and, specifically, was not eligible for tax-free rollover).

(b) Examples.

Example 17:

Employer G maintains a 401(k) plan. The plan provides for nonelective employer contributions, elective deferrals, and employee after-tax contributions. The plan provides that the nonelective contributions vest under a 5-year cliff vesting schedule. The plan provides that when an employee terminates employment, the employee's nonvested account balance is forfeited five years after a distribution of the employee's vested account balance and that forfeitures are used to reduce employer contributions. For the 1998 limitation year, the annual additions made on behalf of two nonhighly compensated employees in the plan, Employees T and U, exceeded the limit in § 415(c). For the 1998 limitation year, Employee T had § 415 compensation of \$60,000, and, accordingly, a § 415(c)(1)(B) limit of \$15,000. Employee T made elective deferrals and employee after-tax contributions. For the 1998 limitation year, Employee U had § 415 compensation of \$40,000, and,

accordingly, a § 415(c)(1)(B) limit of \$10,000. Employee U made elective deferrals. Also, on January 1, 1999, Employee U, who had three years of service with Employer G, terminated his employment and received his entire vested account balance (which consisted of his elective deferrals). The annual additions for Employees T and U consisted of:

| | T | U |
|---------------------------|----------|----------|
| Nonelective Contributions | \$7,500 | \$4,500 |
| Elective Deferrals | 10,000 | 5,800 |
| After-tax Contributions | 500 | 0 |
| | <hr/> | <hr/> |
| Total Contributions | \$18,000 | \$10,300 |
| § 415(c) Limit | \$15,000 | \$10,000 |
| § 415(c) Excess | \$3,000 | \$300 |

Correction:

Employer G uses the SVP correction method to correct the § 415(c) excess with respect to Employee T (i.e., \$3,000). Thus, a distribution of plan assets (and corresponding reduction of the account balance) consisting of \$500 (adjusted for earnings) of employee after-tax contributions and \$2,500 (adjusted for earnings) of elective deferrals is made to Employee T. Employer G uses the forfeiture correction method to correct the § 415(c) excess with respect to Employee U. Thus, the § 415(c) excess is deemed to consist solely of the nonelective contributions. Accordingly, Employee U's nonvested account balance is

reduced by \$300 (adjusted for earnings) which is placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

Example 18:

Employer H maintains a 401(k) plan. The plan provides for nonelective employer contributions, matching contributions and elective deferrals. The plan provides for matching contributions that are equal to 100% of an employee's elective deferrals that do not exceed 8% of the employee's plan compensation for the plan year. For the 1998 limitation year, Employee V had § 415 compensation of \$50,000, and, accordingly, a § 415(c)(1)(B) limit of \$12,500. During that limitation year, the annual additions for Employee V totaled \$15,000, consisting of \$5,000 in elective deferrals, a \$4,000 matching contribution (8% of \$50,000), and a \$6,000 nonelective employer contribution. Thus, the annual additions for Employee V exceeded the § 415(c) limit by \$2,500.

Correction:

Employer H uses the SVP correction method to correct the § 415(c) excess with respect to Employee V (i.e., \$2,500). Accordingly, \$1,000 of the unmatched elective deferrals

(adjusted for earnings) are distributed to Employee V. The remaining \$1,500 excess is apportioned equally between the elective deferrals and the associated matching employer contributions, so Employee V's account balance is further reduced by distributing to Employee V \$750 (adjusted for earnings) of the elective deferrals and forfeiting \$750 (adjusted for earnings) of the associated employer matching contributions. The forfeited matching contributions are placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s). After correction, it is determined that the ADP and ACP tests for 1998 were satisfied.

.05 Other Overpayment Failures.

(1) Correction of Overpayment. An Overpayment, other than one described in section 4.04(1) (relating to a § 415(b) excess) or section 4.04(2) (relating to a § 415(c) excess), may be corrected in accordance with this section 4.05. An Overpayment from a defined benefit plan is corrected in accordance with the rules in section 4.04(1). An Overpayment from a defined contribution plan is corrected in accordance with the rules in section 4.04(2)(a)(iii).

(2) Overpayment Defined. For purposes of this revenue procedure, an Overpayment is defined as a distribution to an employee or beneficiary that exceeds the employee's or

beneficiary's benefit under the terms of the plan because of a failure to comply with plan terms that implement § 401(a)(17), 401(m) (but only with respect to the forfeiture of nonvested matching contributions that are excess aggregate contributions), 411(a)(3)(G), or 415. An Overpayment does not include a distribution of an Excess Amount described in section 3.06(2) (b), (c), (d), or (e).

.06 § 401(a)(17) Failures

(1) Reduction of Account Balance Correction Method. The allocation of contributions or forfeitures under a defined contribution plan for a plan year on the basis of compensation in excess of the limit under § 401(a)(17) for the plan year may be corrected using the reduction of account balance correction method set forth in this paragraph. The account balance of an employee who received an allocation on the basis of compensation in excess of the § 401(a)(17) limit is reduced by this improperly allocated amount (adjusted for earnings). If the improperly allocated amount would have been allocated to other employees in the year of the failure if the failure had not occurred, then that amount (adjusted for earnings) is reallocated to those employees in accordance with the plan's allocation formula. If the improperly allocated amount would not have been allocated to other employees absent the failure, that amount (adjusted for earnings) is placed in an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to

reduce employer contributions in succeeding year(s). For example, if a plan provides for a fixed level of employer contributions for each eligible employee, and the plan provides that forfeitures are used to reduce future employer contributions, the improperly allocated amount (adjusted for earnings) would be used to reduce future employer contributions. (See Example 19.) If a payment was made to an employee and that payment was attributable to an improperly allocated amount, then it is an Overpayment defined in section 4.05(2) that must be corrected (see section 4.05(1)).

(2) Example.

Example 19:

Employer J maintains a money purchase pension plan. Under the plan, an eligible employee is entitled to an employer contribution of 8% of the employee's compensation up to the § 401(a)(17) limit (\$160,000 for 1998). During the 1998 plan year, an eligible employee, Employee W, inadvertently was credited with a contribution based on compensation above the § 401(a)(17) limit. Employee W's compensation for 1998 was \$220,000. Employee W received a contribution of \$17,600 for 1998 (8% of \$220,000), rather than the contribution of \$12,800 (8% of \$160,000) provided by the plan for that year, resulting in an improper allocation of \$4,800.

Correction:

The § 401(a)(17) failure is corrected using the reduction of

account balance method by reducing Employee W's account balance by \$4,800 (adjusted for earnings) and crediting that amount to an unallocated account, similar to the suspense account described in § 1.415-6(b)(6)(iii), to be used to reduce employer contributions in succeeding year(s).

.07 Correction by Amendment Under Walk-in CAP.

(1) § 401(a)(17) Failures. (a) Contribution Correction Method. In addition to the reduction of account balance correction method under section 4.06, an employer may correct a § 401(a)(17) failure for a plan year under a defined contribution plan under the Walk-in Closing Agreement Program ("Walk-in CAP") (in accordance with the requirements of section 11 of Rev. Proc. 98-22) by using the contribution correction method set forth in this paragraph. The employer contributes an additional amount on behalf of each of the other employees (excluding each employee for whom there was a § 401(a)(17) failure) who received an allocation for the year of the failure, amending the plan (as necessary) to provide for the additional allocation. The amount contributed for an employee is equal to the employee's plan compensation for the year of the failure multiplied by a fraction, the numerator of which is the improperly allocated amount made on behalf of the employee with the largest improperly allocated amount, and the denominator of which is the limit under § 401(a)(17) applicable to the year of the failure. The resulting additional amount for each of the other employees is

adjusted for earnings. (See Example 20.)

(b) Examples.

Example 20:

The facts are the same as in Example 19.

Correction:

Employer J corrects the failure under Walk-in CAP using the contribution correction method by (1) amending the plan to increase the contribution percentage for all eligible employees (other than Employee W) for the 1998 plan year and (2) contributing an additional amount (adjusted for earnings) for those employees for that plan year. To determine the increase in the plan's contribution percentage (and the additional amount contributed on behalf of each eligible employee), the improperly allocated amount (\$4,800) is divided by the § 401(a)(17) limit for 1998 (\$160,000). Accordingly, the plan is amended to increase the contribution percentage by 3 percentage points ($\$4,800/\$160,000$) from 8% to 11%. In addition, each eligible employee for the 1998 plan year (other than Employee W) receives an additional contribution of 3% multiplied by that employee's plan compensation for 1998. This additional contribution is adjusted for earnings.

(2) Hardship Distribution Failures. (a) Plan Amendment Correction Method. The Operational Failure of making hardship distributions to employees under a plan that does not provide for

hardship distributions may be corrected under Walk-in CAP (in accordance with the requirements of section 11 of Rev. Proc. 98-22) using the plan amendment correction method set forth in this paragraph. The plan is amended retroactively to provide for the hardship distributions that were made available. This paragraph does not apply unless (i) the amendment satisfies § 401(a), and (ii) the plan as amended would have satisfied the qualification requirements of § 401(a) (including the requirements applicable to hardship distributions under § 401(k), if applicable) had the amendment been adopted when hardship distributions were first made available. (See Example 21.)

(b) Example.

Example 21:

Employer K, a for-profit corporation, maintains a 401(k) plan. Although plan provisions in 1998 did not provide for hardship distributions, beginning in 1998 hardship distributions of amounts allowed to be distributed under § 401(k) were made currently and effectively available to all employees (within the meaning of § 1.401(a)(4)-4). The standard used to determine hardship satisfied the deemed hardship distribution standards in § 1.401(k)-1(d)(2). Hardship distributions were made to a number of employees during the 1998 and 1999 plan years, creating an Operational Failure. The failure was discovered in 2000.

Correction:

Employer K corrects the failure through Walk-in CAP by adopting a plan amendment, effective January 1, 1998, to provide a hardship distribution option that satisfies the rules applicable to hardship distributions in § 1.401(k)-1(d)(2). The amendment provides that the hardship distribution option is available to all employees. Thus, the amendment satisfies § 401(a), and the plan as amended in 2000 would have satisfied § 401(a) (including § 1.401(a)(4)-4 and the requirements applicable to hardship distributions under § 401(k)) if the amendment had been adopted in 1998.

SECTION 5. EARNINGS ADJUSTMENT METHODS AND EXAMPLES

.01 *Earnings Adjustment Methods.* (1) In general. (a) Under section 6.02(3)(a) of Rev. Proc. 98-22, whenever the appropriate correction method for an Operational Failure in a defined contribution plan includes a corrective contribution or allocation that increases one or more employees' account balance (now or in the future), the contribution or allocation is adjusted for earnings and forfeitures. This section 5 provides earnings adjustment methods (but not forfeiture adjustment methods) that may be used by an employer to adjust a corrective contribution or allocation for earnings in a defined contribution plan. Consequently, these earnings adjustment methods may be used to determine the earnings adjustments for corrective contributions or allocations made under the correction methods in

section 4 and under the SVP correction methods in Appendix A, in Rev. Proc. 98-22. If an earnings adjustment method in this section 5 is used to adjust a corrective contribution or allocation, that adjustment is treated as satisfying the earnings adjustment requirement of section 6.02(3)(a) of Rev. Proc. 98-22. Other earnings adjustment methods, different from those illustrated in this section 5, may also be appropriate for adjusting corrective contributions or allocations to reflect earnings.

(b) Under the earnings adjustment methods of this section 5, a corrective contribution or allocation that increases an employee's account balance is adjusted to reflect an "earnings amount" that is based on the earnings rate(s) (determined under section 5.01(3)) for the period of the failure (determined under section 5.01(2)). The earnings amount is allocated in accordance with section 5.01(4).

(c) The rule in section 6.02(4)(a) of Rev. Proc. 98-22 permitting reasonable estimates in certain circumstances applies for purposes of this section 5. For this purpose, a determination of earnings made in accordance with the rules of administrative convenience set forth in this section 5 is treated as a precise determination of earnings. Thus, if the probable difference between an approximate determination of earnings and a determination of earnings under this section 5 is insignificant and the administrative cost of a precise determination would

significantly exceed the probable difference, reasonable estimates may be used in calculating the appropriate earnings.

(d) This section 5 does not apply to corrective distributions or corrective reductions in account balances. Thus, for example, while this section 5 applies in increasing the account balance of an improperly excluded employee to correct the exclusion of the employee under the reallocation correction method described in section 4.02(2)(a)(iii)(B), this section 5 does not apply in reducing the account balances of other employees under the reallocation correction method. (See section 4.02(2)(a)(iii)(C) for rules that apply to the earnings adjustments for such reductions.) In addition, this section 5 does not apply in determining earnings adjustments under the one-to-one correction method described in section 4.01(1)(b)(iii).

(2) Period of the Failure. (a) General Rule. For purposes of this section 5, the "period of the failure" is the period from the date that the failure began through the date of correction. For example, in the case of an improper forfeiture of an employee's account balance, the beginning of the period of the failure is the date as of which the account balance was improperly reduced.

(b) Special Rules for Beginning Date for Exclusion of Eligible Employees from Plan. (i) General Rule. In the case of an exclusion of an eligible employee from a plan contribution, the beginning of the period of the failure is the date on which

contributions of the same type (e.g., elective deferrals, matching contributions, or discretionary nonelective employer contributions) were made for other employees for the year of the failure. In the case of an exclusion of an eligible employee from an allocation of a forfeiture, the beginning of the period of the failure is the date on which forfeitures were allocated to other employees for the year of the failure.

(ii) Exclusion from a 401(k) or (m) Plan. For administrative convenience, for purposes of calculating the earnings rate for corrective contributions for a plan year (or the portion of the plan year) during which an employee was improperly excluded from making periodic elective deferrals or employee after-tax contributions, or from receiving periodic matching contributions, the employer may treat the date on which the contributions would have been made as the midpoint of the plan year (or the midpoint of the portion of the plan year) for which the failure occurred. Alternatively, in this case, the employer may treat the date on which the contributions would have been made as the first date of the plan year (or the portion of the plan year) during which an employee was excluded, provided that the earnings rate used is one half of the earnings rate applicable under section 5.01(3) for the plan year (or the portion of the plan year) for which the failure occurred.

(3) Earnings Rate. (a) General Rule. For purposes of this section 5, the earnings rate generally is based on the investment

results that would have applied to the corrective contribution or allocation if the failure had not occurred.

(b) Multiple Investment Funds. If a plan permits employees to direct the investment of account balances into more than one investment fund, the earnings rate is based on the rate applicable to the employee's investment choices for the period of the failure. In accordance with section 6.03(3)(a) of Rev. Proc. 98-22, for administrative convenience, if most of the employees for whom the corrective contribution or allocation is made are nonhighly compensated employees, the rate of return of the fund with the highest earnings rate under the plan for the period of the failure may be used to determine the earnings rate for all corrective contributions or allocations. If the employee had not made any applicable investment choices, the earnings rate may be based on the earnings rate under the plan as a whole (i.e., the average of the rates earned by all of the funds in the valuation periods during the period of the failure weighted by the portion of the plan assets invested in the various funds during the period of the failure).

(c) Other Simplifying Assumptions. For administrative convenience, the earnings rate applicable to the corrective contribution or allocation for a valuation period with respect to any investment fund may be assumed to be the actual earnings rate for the plan's investments in that fund during that valuation period. For example, the earnings rate may be determined without

regard to any special investment provisions that vary according to the size of the fund. Further, the earnings rate applicable to the corrective contribution or allocation for a portion of a valuation period may be a pro rata portion of the earnings rate for the entire valuation period, unless the application of this rule would result in either a significant understatement or overstatement of the actual earnings during that portion of the valuation period.

(4) Allocation Methods. (a) In General. For purposes of this section 5, the earnings amount generally may be allocated in accordance with any of the methods set forth in this paragraph (4). The methods under paragraph (4)(c), (d), and (e) are intended to be particularly helpful where corrective contributions are made at dates between the plan's valuation dates.

(b) Plan Allocation Method. Under the plan allocation method, the earnings amount is allocated to account balances under the plan in accordance with the plan's method for allocating earnings as if the failure had not occurred. (See Example 22.)

(c) Specific Employee Allocation Method. Under the specific employee allocation method, the entire earnings amount is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made (regardless of whether the plan's allocation method would have allocated the earnings solely to that employee). In determining

the allocation of plan earnings for the valuation period during which the corrective contribution or allocation is made, the corrective contribution or allocation (including the earnings amount) is treated in the same manner as any other contribution under the plan on behalf of the employee during that valuation period. Alternatively, where the plan's allocation method does not allocate plan earnings for a valuation period to a contribution made during that valuation period, plan earnings for the valuation period during which the corrective contribution or allocation is made may be allocated as if that employee's account balance had been increased as of the last day of the prior valuation period by the corrective contribution or allocation, including only that portion of the earnings amount attributable to earnings through the last day of the prior valuation period. The employee's account balance is then further increased as of the last day of the valuation period during which the corrective contribution or allocation is made by that portion of the earnings amount attributable to earnings after the last day of the prior valuation period. (See Example 23.)

(d) Bifurcated Allocation Method. Under the bifurcated allocation method, the entire earnings amount for the valuation periods ending before the date the corrective contribution or allocation is made is allocated solely to the account balance of the employee on whose behalf the corrective contribution or allocation is made. The earnings amount for the valuation period

during which the corrective contribution or allocation is made is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 5.01(4)(b). (See Example 24.)

(e) Current Period Allocation Method. Under the current period allocation method, the portion of the earnings amount attributable to the valuation period during which the period of the failure begins ("first partial valuation period") is allocated in the same manner as earnings for the valuation period during which the corrective contribution or allocation is made in accordance section 5.01(4)(b). The earnings for the subsequent full valuation periods ending before the beginning of the valuation period during which the corrective contribution or allocation is made are allocated solely to the employee for whom the required contribution should have been made. The earnings amount for the valuation period during which the corrective contribution or allocation is made ("second partial valuation period") is allocated in accordance with the plan's method for allocating other earnings for that valuation period in accordance with section 5.01(4)(b). (See Example 25.)

.02 Examples.

Example 22:

Employer L maintains a profit-sharing plan that provides only for nonelective contributions. The plan has a single investment fund. Under the plan, assets are valued annually

(the last day of the plan year) and earnings for the year are allocated in proportion to account balances as of the last day of the prior year, after reduction for distributions during the current year but without regard to contributions received during the current year (the "prior year account balance"). Plan contributions for 1997 were made on March 31, 1998. On April 20, 2000 Employer L determines that an operational failure occurred for 1997 because Employee X was improperly excluded from the plan. Employer L decides to correct the failure by using the SVP correction method for the exclusion of an eligible employee from nonelective contributions in a profit-sharing plan. Under this method, Employer L determines that this failure is corrected by making a contribution on behalf of Employee X of \$5,000 (adjusted for earnings). The earnings rate under the plan for 1998 was +20%. The earnings rate under the plan for 1999 was +10%. On May 15, 2000, when Employer L determines that a contribution to correct for the failure will be made on June 1, 2000, a reasonable estimate of the earnings rate under the plan from January 1, 2000 to June 1, 2000 is +12%.

Earnings Adjustment on the Corrective Contribution:

The \$5,000 corrective contribution on behalf of Employee X is adjusted to reflect an earnings amount based on the earnings rates for the period of the failure (March 31, 1998

through June 1, 2000) and the earnings amount is allocated using the plan allocation method. Employer L determines that a pro rata simplifying assumption may be used to determine the earnings rate for the period from March 31, 1998 to December 31, 1998, because that rate does not significantly understate or overstate the actual earnings for that period. Accordingly, Employer L determines that the earnings rate for that period is 15% (9/12 of the plan's 20% earnings rate for the year). Thus, applicable earnings rates under the plan during the period of the failure are:

| Time Periods | Earnings Rate |
|---|---------------|
| 3/31/98 - 12/31/98 (First Partial Valuation Period) | +15% |
| 1/1/99 - 12/31/99 | +10% |
| 1/1/00 - 6/1/00 (Second Partial Valuation Period) | +12% |

If the \$5,000 corrective contribution had been contributed for Employee X on March 31, 1998, (1) earnings for 1998 would have been increased by the amount of the earnings on the additional \$5,000 contribution from March 31, 1998 through December 31, 1998 and would have been allocated as 1998 earnings in proportion to the prior year (December 31, 1997) account balances, (2) Employee X's account balance as of December 31, 1998 would have been increased by the additional \$5,000 contribution, (3) earnings for 1999 would have been increased by the 1999 earnings on the additional \$5,000 contribution (including 1998 earnings thereon)

allocated in proportion to the prior year (December 31, 1998) account balances along with other 1999 earnings, and (4) earnings for 2000 would have been increased by the earnings on the additional \$5,000 (including 1998 and 1999 earnings thereon) from January 1 to June 1, 2000 and would be allocated in proportion to the prior year (December 31, 1999) account balances along with other 2000 earnings. Accordingly, the \$5,000 corrective contribution is adjusted to reflect an earnings amount of \$2,084 ($\$5,000[(1.15)(1.10)(1.12)-1]$) and the earnings amount is allocated to the account balances under the plan allocation method as follows:

- (a) Each account balance that shared in the allocation of earnings for 1998 is increased, as of December 31, 1998, by its appropriate share of the earnings amount for 1998, \$750 ($\$5,000(.15)$).
- (b) Employee X's account balance is increased, as of December 31, 1998, by \$5,000.
- (c) The resulting December 31, 1998 account balances will share in the 1999 earnings, including the \$575 for 1999 earnings included in the corrective contribution ($\$5,750(.10)$), to determine the account balances as of December 31, 1999. However, each account balance other than Employee X's account balance has already shared in the 1999 earnings, excluding the \$575. Accordingly, Employee X's

account balance as of December 31, 1999 will include \$500 of the 1999 portion of the earnings amount based on the \$5,000 corrective contribution allocated to Employee X's account balance as of December 31, 1998 ($\$5,000(.10)$). Then each account balance that originally shared in the allocation of earnings for 1999 (i.e., excluding the \$5,500 additions to Employee X's account balance) is increased by its appropriate share of the remaining 1999 portion of the earnings amount, \$75.

(d) The resulting December 31, 1999 account balances (including the \$5,500 additions to Employee X's account balance) will share in the 2000 portion of the earnings amount based on the estimated January 1, 2000 to June 1, 2000 earnings included in the corrective contribution equal to \$759 ($\$6,325(.12)$). (See Table 1.)

TABLE 1
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|--|---------------|------------------|---|
| Corrective Contribution | | \$5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750 ¹ | All 12/31/1997 Account Balances ⁴ |
| 1999 Earnings | 10% | 575 ² | Employee X (\$500)/ All 12/31/1998 Account Balances (\$75) ⁴ |
| Second Partial Valuation Period Earnings | 12% | 759 ³ | All 12/31/1999 Account Balances (including Employee X's \$5,500) ⁴ |

| | | | |
|--------------------------|--|---------|--|
| Total Amount Contributed | | \$7,084 | |
|--------------------------|--|---------|--|

¹\$5,000 x 15%

²\$5,750(\$5,000 +750) x 10%

³\$6,325(\$5,000 +750 +575) x 12%

⁴After reduction for distributions during the year for which earnings are being determined but without regard to contributions received during the year for which earnings are being determined.

Example 23:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the specific employee allocation method. Thus, the entire earnings amount for all periods through June 1, 2000 (i.e., \$750 for March 31, 1998 to December 31, 1998, \$575 for 1999, and \$759 for January 1, 2000 to June 1, 2000) is allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of \$7,084 ($\$5,000(1.15)(1.10)(1.12)$). Employee X's account balance as of December 31, 2000 is increased by \$7,084. Alternatively, Employee X's account balance as of December 31, 1999 is increased by \$6,325 ($\$5,000(1.15)(1.10)$), which shares in the allocation of earnings for 2000, and Employee X's account balance as of December 31, 2000 is increased by the remaining \$759. (See Table 2.)

TABLE 2
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|--|---------------|------------------|---------------|
| Corrective Contribution | | \$5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750 ¹ | Employee X |
| 1999 Earnings | 10% | 575 ² | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759 ³ | Employee X |
| Total Amount Contributed | | \$7,084 | |

¹\$5,000 x 15%

²\$5,750(\$5,000 +750) x 10%

³\$6,325(\$5,000 +750 +575) x 12%

Example 24:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the bifurcated allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) and the earnings for 1999 are allocated to Employee X. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of \$7,084

($\$5,000(1.15)(1.10)(1.12)$). Employee X's account balance as of December 31, 1999 is increased by \$6,325 ($\$5,000(1.15)(1.10)$); and the December 31, 1999 account balances of employees (including Employee X's increased account balance) will share in estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to \$759 ($\$6,325(.12)$). (See Table 3.)

TABLE 3
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|--|---------------|------------------|---|
| Corrective Contribution | | \$5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750 ¹ | Employee X |
| 1999 Earnings | 10% | 575 ² | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759 ³ | 12/31/99 Account Balances (including Employee X's \$6,325) ⁴ |
| Total Amount Contributed | | \$7,084 | |

¹\$5,000 x 15%

²\$5,750(\$5,000 +750) x 10%

³\$6,325(\$5,000 +750 +575) x 12%

⁴ After reduction for distributions during the 2000 year but without regard to contributions received during the 2000 year .

Example 25:

The facts are the same as in Example 22.

Earnings Adjustment on the Corrective Contribution:

The earnings amount on the corrective contribution is the same as in Example 22, but the earnings amount is allocated using the current period allocation method. Thus, the earnings for the first partial valuation period (March 31, 1998 to December 31, 1998) are allocated as 2000 earnings. Accordingly, Employer L makes a contribution on June 1, 2000 to the plan of \$7,084 ($\$5,000 (1.15)(1.10)(1.12)$). Employee X's account balance as of December 31, 1999 is increased by the sum of \$5,500 ($\$5,000(1.10)$) and the remaining 1999 earnings on the corrective contribution equal to \$75 ($\$5,000(.15)(.10)$). Further, both (1) the estimated March 31, 1998 to December 31, 1998 earnings on the corrective contribution equal to \$750 ($\$5,000(.15)$) and (2) the estimated January 1, 2000 to June 1, 2000 earnings on the corrective contribution equal to \$759 ($\$6,325(.12)$) are treated in the same manner as 2000 earnings by allocating these amounts to the December 31, 2000 account balances of employees in proportion to account balances as of December 31, 1999 (including Employee X's increased account balance). (See Table 4.) Thus, Employee X is allocated the earnings for the full valuation period during the period of the failure.

TABLE 4
CALCULATION AND ALLOCATION OF THE
CORRECTIVE AMOUNT ADJUSTED FOR EARNINGS

| | Earnings Rate | Amount | Allocated to: |
|--|---------------|------------------|---|
| Corrective Contribution | | \$5,000 | Employee X |
| First Partial Valuation Period Earnings | 15% | 750 ¹ | 12/31/99 Account Balances (including Employee X's \$5,575) ⁴ |
| 1999 Earnings | 10% | 575 ² | Employee X |
| Second Partial Valuation Period Earnings | 12% | 759 ³ | 12/31/99 Account Balances (including Employee X's \$5,575) ⁴ |
| Total Amount Contributed | | \$7,084 | |

¹\$5,000 x 15%

²\$5,750(\$5,000 +750) x 10%

³\$6,325(\$5,000 +750 +575) x 12%

⁴ After reduction for distributions during the year for which earnings are being determined but without regard to contributions received during the year for which earnings are being determined.

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 98-22 clarified and supplemented. Rev. Proc. 98-22 is clarified and supplemented by this revenue procedure.

SECTION 7. EFFECTIVE DATE

The effective date of this revenue procedure is January 1,

2000. In addition, employers are permitted, at their option, to apply the provisions of this revenue procedure on or after March 9, 1998 (the release date of Rev. Proc. 98-22). Unless a plan sponsor applies the provisions of this revenue procedure earlier, this revenue procedure is effective:

- (1) with respect to VCR and Walk-in CAP, for applications submitted on or after January 1, 2000;
- (2) with respect to Audit CAP, for examinations begun on or after January 1, 2000; and
- (3) with respect to APRSC, for failures for which correction is not complete before May 1, 2000.

SECTION 8. PAPERWORK REDUCTION ACT

The collection of information contained in this revenue procedure has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1656.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in sections 3.04 and 4.01 - 4.07. This information is required to enable the Office of Assistant Commissioner (Employee Plans and Exempt Organizations) of the Internal Revenue Service to make determinations regarding the issuance of certain closing

agreements and to ascertain if plan participants have been notified of certain actions. This information can allow individual plans to continue to maintain their tax qualified status. As a result, favorable tax treatment of the benefits of the eligible employees is retained. The likely respondents are individuals, state or local governments, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 10,800 hours.

The estimated annual burden per respondent/recordkeeper varies from 2 to 12 hours, depending on individual circumstances, with an estimated average of 10.8 hours. The estimated number of respondents and/or recordkeepers is 1,000.

The estimated annual frequency of responses is occasionally.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal authors of this revenue procedure are Jeanne Royal Singley and Maxine Terry of the Employee Plans Division. For more information concerning this revenue procedure, call the

Employee Plans Division's taxpayer assistance telephone service at (202) 622-6074/6075 (not toll-free numbers) between the hours of 1:30 and 3:30 p.m. Eastern Time, Monday through Thursday. Ms. Singley and Ms. Terry may be reached at (202) 622-6214 (also not a toll-free number).