Retirement Income
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IRS relaxes penalty that discouraged auto-enrollment

By Editorial Staff *Thu, Apr 9, 2015*

A penalty on plan sponsors for failing to make scheduled deferrals to auto-enrolled plan participants was identified as a barrier to adoption of auto-enrollment into retirement plans, so the IRS has conditionally removed it, on a trial basis, until 2021.

The Internal Revenue Service will no longer levy a 50% penalty on employers who accidentally miss making payroll deferrals to the retirement accounts of employees who had been automatically enrolled into their plans and were eligible for deferrals, as long as they correct the mistake in a timely manner.

In announcing the new **policy** at a meeting of the Defined Contribution Institutional Investors Association meeting in Washington, D.C. on April 2, deputy Treasury secretary Mark Iwry explained that the penalty was causing some employers not to adopt auto-enrollment—and was therefore counterproductive.

"The rules for correcting slip-ups will be less costly, burdensome, and address the perception of a windfall [to the employee]," Iwry said. "We still think the employees have lost something value in the way of tax-free buildup. But we agree that an added 50% employer contribution sounds disproportionate."

Auto-enrollment itself is considered essential by the government and private industry to the goal of expanding participation in workplace retirement plans and increasing American workers' financial preparedness for retirement. Auto-enrollment of new employers (with optional disenrollment) has been shown to dramatically increase participation rates.

This type of ruling is known as a "safe harbor," because it defines a procedure, which, if followed, will not result in a violation of the Employee Retirement Income Security Act of 1974 (ERISA).

"With respect to auto-enrollment, the main advantage of the new safe harbor is not having to pay the 50% QNEC (Qualified Non-elective Contribution) (QNEC) or any QNEC at all," Bill Evans of the IRS told the DCIAA audience. "But you'd still have to make up for lost matches and the lost earnings on the match. There is also a requirement to issue a notice about the failure to make deferrals and the correction," so that employees can make catch-up deferrals if they choose.

The original penalty was created in 2006 when the Pension Protection Act allowed auto-enrollment. It applied to employers who failed to make a required deferral into an auto-enrolled employee's retirement account. As a penalty, the employer had to make an extra payment to the account equal to 50% of the unmade deferrals.

The "principle underlying the 50% make-up corrective contribution was that corrective contributions should make up for the value of the lost opportunity for an employee to have a portion of his or her compensation accumulate with earnings tax deferred in the future," a recent IRS release said.

The employer would still have to make up for any lost matching contributions. And, for full relief from penalties, the correction would have to be made no later than 9½ months into the year after the year of the mistake.

Employers objected to the 50% corrective contribution on the grounds that it represented a "windfall" for employees and that the errors were usually corrected after a few months—thus giving employees many years to catch-up on lost tax-deferred growth. The IRS noted the employer complaint that, ironically, "errors are more common for plans with automatic contribution features (particularly automatic escalation features).

The new relief will expire in 2021. "It's a little bit of a pilot," Iwry told a crowd of several hundred defined contribution industry executives at the Mandarin Oriental Hotel in Washington last week. "Having no employer contribution is stepping out a bit relative to the past. We want to make sure it's workable and has the intended effect of encouraging the spread of auto-enrollment."

The IRS also announced that, for failures to make deferrals in plans that do not involve auto-enrollment, the QNEC will be zero if the failure is corrected within 90 days. It will be 25% if the failure is corrected by the end of the year after the year of the failure, and 50% thereafter, an IRS spokesperson told RIJ.