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Employee Benefits Corner

IRS Gives “Inadvertent Benefit Overpayments” Their First Round of Guidance

By Elizabeth Thomas Dold and David N. Levine

Section 301 of the Setting Every Community Up for Retirement Enhancement (SECURE) 2.0 Act (Pub. L. 117-328) grants plan sponsors flexibility in correcting “inadvertent plan overpayments,” which includes allowing participants to keep the overpayments without the plan sponsor having to make the plan whole. It also permits certain overpayments to be treated as eligible rollover distributions, which helps avoid the 6% annual excise tax for amounts inadvertently rolled over to an individual retirement account (IRA) and having to correct the Form 1099-R.

This SECURE 2.0 rule has both Department of Labor (DOL) and Internal Revenue Service (IRS) components, with the DOL rules for Employee Retirement Income Security Act of 1974 (ERISA) covered plans providing for an added layer of protection for participants. Specifically, the ERISA provisions generally impose strict recovery measures if the plan sponsor elects to seek recovery of the overpayment. Notably, these restrictions are not set forth under the Internal Revenue Code (the “Code”) provisions, nor are they added *via* this first round of IRS guidance, which is set forth in Notice 2024-77. Notice 2024-77 is effective as of October 15, 2024, and provides interim guidance to help plan sponsors understand the correction options available to correct plan overpayments and maintain the tax-qualified status of the qualified plan.

Background

Prior to SECURE 2.0, plan sponsors were generally required under the Code to take corrective action to recover overpayments and to inform the participant that the overpayment was not eligible for favorable tax treatment, including tax-free rollover treatment. The IRS set forth pre-approved correction methods applicable for defined contribution and defined benefit plans, in accordance with Rev. Proc. 2021-30 (Employee Plans Compliance Resolution System (EPCRS)). Similarly, ERISA generally required fiduciaries to attempt to recoup overpayments (or otherwise make the plan whole).

Following SECURE 2.0, effective for corrections on or after December 29, 2022, regardless of the date of the overpayment, a plan sponsor is generally

permitted to allow participants to keep the overpayment (if desired) without having to make the Plan whole. But if the plan sponsor wants to continue to seek recovery, ERISA restrictions were placed on those collection actions. For Code purposes, this Notice provides guidance on the available correction options available to plan sponsors. Importantly, the Notice clarifies that plan sponsors may continue to seek recoupment of inadvertent benefit overpayments from participants and beneficiaries. However, for ERISA-covered plans, the restrictions set forth under ERISA section 206(h) apply, for which unfortunately this Notice does not provide any insight.

Plan sponsors should review their overpayment procedures in light of SECURE 2.0 and Notice 2024-77, including their rollover treatment and reporting and withholding process.

Pending additional guidance, the Notice provides for a good faith, reasonable compliance standard (which to the extent the Notice is followed, it is deemed to have been met).

Plans Covered

The following types of plans are covered by this relief: a Code Sec. 401(a) qualified plan, Code Sec. 403(a) annuity, Code Sec. 403(b) tax-sheltered annuity, or a governmental plan (hereinafter, qualified plan).

Failure Covered

The Notice defines what is an “inadvertent benefit overpayment.” It is an eligible inadvertent failure (as defined in section 305(e) of SECURE 2.0 Act, see below) that occurs due to a payment made from a qualified plan that exceeded the amount payable under the terms of the plan or a limitation provided in the Code or regulations. This includes a payment made before a distribution is permitted under the Code or under the terms of the plan (*i.e.*, an impermissible in-service distribution).

However, an inadvertent benefit overpayment **does not** include (i) a payment made to a disqualified person as defined in Code Sec. 4975(e)(2) or owner-employee

as defined in Code Sec. 401(c), or (ii) a payment that is made pursuant to a correction method provided under Rev. Proc. 2021-30 for a different qualification failure.

An “eligible inadvertent failure” is a failure that (1) occurs despite the existence of established practices and procedures (*see* section 4.04 of Rev. Proc. 2021-30), (2) is not egregious, (3) does not relate to the diversion or misuse of plan assets, and (4) is not directly or indirectly related to an abusive tax avoidance transaction.

Impact on EPCRS Corrections

Overpayments, even inadvertent benefit overpayments, can still be corrected under the existing pre-approved correction methods set forth in EPCRS. *See* sections 6.06 and 2.04 or 2.05 of Appendix B of Rev. Proc. 2021-30. The overpayment is still treated as not eligible for tax-free rollover treatment if not repaid to the plan. Alternatively, except for the failures listed below, no correction action is required and the participant/beneficiary can retain the overpayment, and the plan sponsor is not required to make a corrective make-whole payment to the plan. However, the existing EPCRS overpayment correction should be followed, including the requirement to make a corrective make-whole payment to the plan if the overpayment is not recovered, if the overpayment failure involves the following:

- a Code Sec. 401(a)(17) (compensation limit) failure;
- a Code Sec. 415 (contribution and benefit limits) failure;
- a Code Sec. 436 (defined benefit funding-based restrictions) failure;
- an incorrect allocation of a profit-sharing contribution under a plan resulting in benefit underpayments to others; or
- an impermissible forfeiture in accordance with Code Sec. 411.

More specifically, the following provisions of Rev. Proc. 2021-30 (EPCRS) are modified or no longer applicable with respect to an inadvertent benefit overpayment:

- the definition of “overpayment” is revised by Notice 2024-77;
- the requirement to notify an individual that an overpayment is not an eligible rollover distribution no longer applies if recoupment is not sought (or sought and returned);
- the requirement of a corrective payment (other than as noted above for Code Sec. 401(a)(17), 415, or 436 failures or resulting impermissible forfeitures); and

- the 6% excise tax (Code Sec. 4973) and additional 10% tax (Code Sec. 72(t)) relief no longer apply if an overpayment is eligible for rollover treatment.

Importantly, to the extent that recovery efforts are made, the ERISA restrictions on recoupment from participants/beneficiaries generally apply.

Eligible Rollover Distributions

The rollover treatment of the overpayment depends on the type of failure and correction method selected, as follows:

Seek Recovery

- **Participant/Beneficiary Repays:** The inadvertent benefit overpayment is treated as an eligible rollover distribution (if it otherwise would have been absent the overpayment). Therefore, regardless of plan terms, the amount that is sought and transferred back to the originating plan is treated both as an eligible rollover distribution from the originating plan and as an eligible rollover distribution transferred back to the originating plan.
- **Participant/Beneficiary Does Not Repay:** The inadvertent benefit overpayment is not treated as an eligible rollover distribution, and the plan sponsor must notify the individual that the unreturned portion is not eligible for favorable tax treatment (*i.e.*, not eligible for tax-free).

Do Not Seek Recovery

The inadvertent benefit overpayment is treated as an eligible rollover distribution to the extent the overpayment would otherwise be treated as such (absent the fact that it is an overpayment). However, if the overpayment is attributable to a Code Sec. 401(a)(17) or 415 failure, the overpayment is not an eligible rollover distribution.

Special Rules for Code Secs. 401(a)(17), 415, and 436 failures

For a Code Sec. 436 failure that occurs as a result of an inadvertent benefit overpayment, to the extent the overpayment is not recouped on behalf of the plan from the recipient, the plan sponsor or another person must make a corrective payment under the applicable EPCRS provisions.

For a Code Sec. 415 or 401(a)(17) failure, a plan must observe the limitations imposed by Code Secs. 401(a)(17) and 415 and may enforce those limitations using any method approved by the IRS for recouping benefits previously paid or allocations previously made in excess of those limitations. Therefore, a corrective payment must be made to the plan (either by the individual or the plan sponsor or another party) in accordance with EPCRS.

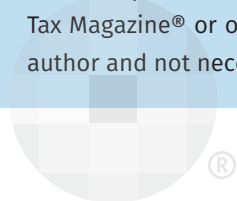
Plan sponsors have more flexibility to not recover plan overpayments from individuals and avoid a make-whole payment, but documentation of that approach is still recommended for the plan files.

Notably, although a plan sponsor has the ability to correct inadvertent benefit overpayments by plan amendment, an amendment to increase past benefit payments in a manner that results in a violation of Code Sec. 401(a)(17) or 415 for a past year is not permitted. Similarly, an amendment to increase past benefits that results in a Code Sec. 436 failure for a past year is permitted only if contributions are made in accordance with Code Sec. 436(c)(2) and section 6.02(4) of Rev. Proc. 2021-30.

Next Steps

Plan sponsors should review their overpayment procedures in light of SECURE 2.0 and Notice 2024-77, including their rollover treatment and reporting and withholding process. Plan sponsors have more flexibility to not recover plan overpayments from individuals and avoid a make-whole payment, but documentation of that approach is still recommended for the plan files. And plan sponsors wanting to take action to collect from a participant/beneficiary need to be mindful of the new ERISA recoupment restrictions.

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