

What are corrective distributions and how to avoid them going forward

TESTS – the word alone is enough to make the most studious of us sweat. When placed in the context of 401(k) plans, i.e. determining whether your plan passes non-discrimination tests, anxiety levels can go through the roof!



This article will take a brief look at ways to correct a failed “ADP” test, the non-discrimination test mandated by the Internal Revenue Code to determine whether 401(k) elective deferrals unfairly favor highly-compensated employees and using corrective distributions, a method available to fix a failed test. It also outlines a few changes that can be made mid-year to improve test results and explains how to avoid the ADP test altogether.

When Your Plan Fails the Test

Typically, the ADP test is done shortly after the end of the plan year, and if your plan fails, corrections are made in accordance with certain procedures and time frames.

Generally, the plan document specifies the correction procedure; the most common method requires the plan sponsor to first recharacterize excess amounts as “catch-up” contributions, if possible, and then to make corrective distributions to the highly-compensated employees.

Highly-Compensated Employees (HCE): Highly-compensated employees are those employees who own or are deemed to own through family attribution more than 5% of a business at any time during the current or prior plan year OR employees who had compensation in excess of a specific dollar amount in the prior plan year (\$120,000 for 2019 plan year testing).

Consequently, highly-compensated employees are not only unable to take full advantage of saving for retirement, but the refund of the corrective distributions means they will face additional federal and state income taxes. *Basically, these persons have to refile their taxes, which is time consuming and costly, and will have to pay appropriate taxes on the corrective amount.*

OR, there is another option. If the plan sponsor chooses, they could make additional contributions to the non-highly compensated employees to correct a failed ADP test.

Although making corrective distributions to the highly-compensated employees or additional contributions to the non-highly compensated employees will resolve a failed ADP test, there are other options a plan sponsor can adopt on a proactive basis.

Proactive Steps to Not Fail the Test

One option is to have the ADP test done mid-year to get an early assessment. If it looks as

though the plan won't pass, here are three ideas to prevent failure:

1. Restrict the amount of contributions that highly-compensated employees may make to the plan to either a uniform dollar amount or percentage of compensation
2. Implement matching contributions to encourage non-highly-compensated employees to participate at higher levels
3. Add an automatic enrollment feature with automatic annual increases to increase the non-highly-compensated employees' deferral percentages

Additionally, greater communication can help increase highly-compensated employee's awareness of possible corrective distributions, while better matching and enrollment initiatives can help to boost plan participation.

Skip the Test

There is one way to completely eliminate the ADP test. It is to adopt a safe harbor design for the plan.

A safe harbor plan design requires specific contribution, vesting and participant notification provisions.

If the thought of failing ADP testing makes your blood pressure spike, take a deep breath and read these 3 tips!

The three basic contribution options include:

- Contribute 3% of salary for all eligible employees (non-elective)
- Match contributions consisting of 100% up to 3% of compensation and a 50% match on the next 2% of compensation (elective)
- Match contributions consisting of 100% up to 1% of compensation and a 50% match on the next 5% of compensation combined with an automatic enrollment feature (a "QACA")

Keep in mind that adopting a safe harbor plan will eliminate the ADP test requirement for future plan years only. It cannot be adopted retroactively or mid-year to alleviate a failed ADP test for the current plan year.

A safe harbor plan can only be offered for an entire plan year; and since most plans have a 1/1 start date that could be good news if you think you will be failing the ADP test in the near future. Keep in mind that there are notification requirements and that participants must be notified 30 to 90 days prior to the start of each plan year, so if this is something you're interested in, setup a call with your service provider today.

Non-discrimination testing is an integral part of sponsoring a 401(k) plan, but there is no need to have anxiety about the ADP test. There are ways to correct a failed test and improve the test results if a failure seems likely as well as ways to avoid the test altogether.

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