Deadlines to Correct for Failed ADP and ACP Testing

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March 15th is a magical deadline for calendar year plans in the 401(k) testing world. After the end of each plan year, Plan Sponsors and Third Party Administrators (TPAs) work in a frenzy to complete important ADP and ACP testing early so that any necessary refunds can be made on or before March 15th (or 2 ½ months after the end of the plan year). Refunds which are distributed after the 2 ½ month deadline are subject to a 10% excise tax (except for plans that contain an automatic enrollment feature that satisfies certain requirements, in which case the distribution deadline is extended to June 30th – or 6 months after the plan year-end).

ADP (Actual Deferral Percentage) and ACP (Actual Contribution Percentage) testing is required each year for non-Safe Harbor 401(k) plans to demonstrate satisfaction of the nondiscrimination rules related to 401(k) and employer matching contributions. The salary deferral and matching contributions made on behalf of the Highly Compensated Employees (HCEs) cannot exceed the salary deferral and matching contributions made on behalf of the Nonhighly Compensated Employees (NHCEs) by more than a specified amount. If either or both tests fail, the plan generally must correct the failure by either (1) distributing the excess contributions to the Highly Compensated Employees or by (2) making an additional fully vested contribution to the plan on behalf of the Nonhighly Compensated Employees. Usually the least expensive option is to distribute the excess amounts to the HCEs.

Although on the surface ADP and ACP testing seems fairly straightforward, the testing can quickly become very complicated. Consideration must be given to the types of contributions that are made to the plan, particularly if the plan contains prevailing wage contributions, catch-up contributions, Roth deferrals or traditional after-tax contributions. The determination of HCEs and NHCEs requires a careful analysis of employee compensation and family attribution rules. Certain employees who have terminated or who were not eligible for a matching contribution may be excluded from the testing. The testing and corrective actions can be performed in a variety of ways, utilizing special techniques like "borrowing" from one test to satisfy another test and/or using permissive disaggregation to divide the employees into separate testing groups. *But after all of the various testing options are considered, if either the ADP or ACP test fails and it is determined that distributions must be made to the HCEs, it is important to understand the deadlines that apply and the consequences of failing to meet the specific deadlines.*

Testing refunds distributed within the 2 ½ month deadline

If the corrective refunds, including earnings, are made by March 15th for a calendar year plan, or within 2 ½ months of year-end for a non-calendar year plan, then the testing failure is considered to be resolved. There is no excise tax imposed on the refunded amount. The distribution is taxable to the HCE for the taxable year in which it is distributed.

Testing refunds distributed after March 15th but before 12 months after plan year-end

If HCE refunds, including earnings, are made after March 15th for a calendar year plan, or after the first 2 ½ months of the plan year for a non-calendar year plan, then the employer must pay a 10% excise tax on the excess contributions, in addition to distributing the refunds. The excise tax is reportable on Form 5330, which must be filed by the last day of the 15th month after the close of the plan year to which the excess contributions relate. Once the refunds are distributed and the Form 5330 is filed with the payment of the excise tax, then the testing failure is resolved. *As mentioned earlier in the article, the Form 5330 and excise tax do not apply until after the first 6 months after the end of the plan year for plans that use certain qualifying automatic contribution features*. The distribution is taxable to the HCE for the taxable year in which it is distributed.

Testing refunds not distributed in the first 12 months following the end of the plan year

Under current regulations, testing failures are required to be corrected within 12 months after the close of the plan year. However, the Internal Revenue Service provides a self-correction program that can be used within 36 months of the close of the plan year, but the costs can be significantly more than if the failure is corrected timely. The correction steps for distributions made after 12 months are:

1. The failed test may be corrected by either (1) making a fully vested contribution to the plan on behalf of the Nonhighly Compensated Employees to the extent necessary to raise the contribution level to a passing percentage or (2) using the "one-to-one correction method", whereby excess contributions, plus earnings, are distributed to the HCEs AND that same dollar amount is then contributed to the plan to the NHCEs.
2. Since the refunds are being made more than 2 ½ months after year end, it is necessary to file Form 5330 and pay a 10% excise tax. If the Form 5330 is filed more than 15 months after plan year-end, there may be late fees assessed. Also, distributions to HCEs are taxable for the taxable year in which they are distributed.
3. Permissive disaggregation is not allowed as a testing technique when performing the tests. The ADP and ACP tests must be performed by including all NHCEs and all HCEs in each test. This can result in much larger refunds than if the testing had been

performed by disaggregating the employees into separate testing groups and running separate tests.

While a plan may occasionally miss the March 15th distribution deadline, the 10% excise tax is usually not a big issue- especially if the required refunds are small. However, going beyond 12 months to correct can result in severe and costly consequences for plans due to the disaggregated testing method no longer being available and the additional contribution that must be made for the NHCEs. Plan sponsors need to give serious thought to retaining an outside TPA to perform this critical testing and for monitoring the distribution deadlines to ensure accurate and timely testing and necessary corrections.