Money Back is Good, Right?

Refunds can be great if you are referring to tax returns or money back from an unsatisfied purchase. However, when it comes to your company’s retirement plan, refunds or corrective distributions are red flags indicating a deeper problem. They can be an administrative nightmare for plan sponsors and cause undue stress to highly-compensated employees who may be forced to refile their taxes.

What are Corrective Distributions?

Employees within your workforce are divided into two groups: highly-compensated employees (HCE) and non-highly compensated employees (NHCE).

Highly Compensated Employee (HCE):
One who owns 5% or more of the company or earns more than $120,000 per year.

Both groups have a desire to retire and contribute what they can to the company’s defined contribution plan, however their difference in pay will affect the amount which they can put away annually. As a check on plan design equality, the IRS requires that both HCEs and NHCEs contribute to their 401(k) plans at similar percentages. If owners and managers contribute at far higher rates than their workers over the course of the year, the amount “over paid” will be refunded, which poses a problem for all parties involved.

Corrective distributions can be frustrating for both employees and plan sponsors alike. The highly-compensated employees who receive refunds must account for previously tax-deferred savings in their net pay which would then be subject to income taxes. For plan sponsors, corrective distributions are burdensome from an administrative standpoint. Repeat offenders may find it difficult to hold onto valuable employees, experience more paper work, or even face legal ramifications if timely corrections are not made.

The IRS keeps a stern eye out for corrective distributions and requires plans with over 100 employees to run nondiscrimination tests. In 2015, nearly 54,500 401(k) plans failed retirement plan testing, requiring plan sponsors to return nearly $820 million in 401(k) contributions to highly-compensated employees.[1]

What is Nondiscrimination Testing?

Nondiscrimination tests were created to help demonstrate that your plan provides comparable benefits for all employees. To calculate the applicable corrective distribution, the IRS uses a formula called the Actual Deferral Percentage (ADP). The ADP test compares the average salary deferral among HCEs to that of NHCEs as a percentage of pre-tax compensation. The requirements to pass the ADP test are as follows:

If the average ADP for NHCEs is:

- less than 2%
- between 2% and 8%
- More than 8%

Then the maximum Average ADP for HCEs is:

- 2 times the average ADP for NHCEs
- the average ADP for NHCEs plus 2%
- 1.25 times the average ADP for NHCEs

Avoiding Corrections

Establishing a Safe Harbor 401(k) Plan may be one way to avoid costly refunds by omitting the need for testing. Under a Safe Harbor, if a plan meets certain requirements, the employer isn't required to perform nondiscrimination tests.

Additionally, optimizing plan design with features such as auto enrollment and auto escalation, offering profit sharing contributions, or educating employees on the benefits of participating in a retirement plan may help with testing failures.

Building an effective retirement plan that meets the goals of the company and your employees (HCEs & NHCEs) can be confusing. It's important to partner with a team that understands these complexities and

[1] http://www.judydiamond.com/alms-judy-diamond-associates-analysis-reveals-54000-401k-plans-failed-nondiscrimination-testing/

can help you implement a prudent fiduciary process to assist you and your employees in your pursuit of a meaningful retirement.

> **We are the premier 401k plan specialist in Arizona, providing state of the art plan design, management and employee education to assure maximum employee participation and satisfaction. We believe all employees should have the opportunity to secure a financially sound retirement and we manage the plan solely for the participants so they may achieve their goals.**

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