



## Correcting Average Deferral Percentage Test Failures



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The tax code governing 401(k) plans was written to prevent qualified retirement plans from overly favoring highly compensated employees (HCEs). A series of non-discrimination tests were devised to measure whether a plan's design or operation tends to favoring the HCEs over the nonhighly compensated employees (NHCEs). In our last installment we discussed how the Average Deferral Percentage (ADP) test is calculated. In this article we dive into the different methods of correcting for an ADP test failure

### Correcting ADP Failures: Refunds to HCEs

There are generally two ways to correct a failed ADP/ACP test. The most-popular correction method is to refund "excess" deferrals to HCEs. The refund calculation is a two-step process. First, the total refund amount is determined by calculating the total percentage points that must be refunded to satisfy the ADP test.

The next step calculates the dollars which would be refunded if the excess percentages were refunded first to the HCE with the highest deferral percentage until either the total excess percentages are refunded or until the resulting deferral percentage of that HCE equals that of the HCE with the next-highest deferral percentage. If the test is still not satisfied, both HCEs are reduced together until the test is satisfied, and so forth.

The final step determines how much each HCE is to be refunded. This is calculated by first allocating the total refund to the HCE with the highest deferral, in terms of dollars, until the total refund is applied or until the deferral of such HCE is reduced to that of the HCE with the next highest deferral, and so forth.

The amount refunded is considered a taxable distribution from the plan, and is reported as taxable income to the participant in the year it is distributed from the plan. The corrective distribution is required to be completed by March 15th of the year following the year the excess contribution occurred. If completed after March 15th of the following plan year, it is still considered to be taxable income in the year paid, however in addition, the Internal Revenue Code imposes a 10% excise tax on the employer.

### Correcting ADP Failures: QNECs

While a refund is the most-popular method of correcting an ADP failure, it is not always the most beneficial. The primary reason is that the HCEs, often the owners of the company or its most-valuable employees, lose-out on the tax deferral aspects of contributions to a 401(k) plan. An alternate method of satisfying the test is for the employer to make a Qualified Non-elective Contribution ("QNEC"). A QNEC is an employer contribution that is fully-vested when made and subject to the same distribution limitations otherwise applicable to section 401(k) contributions. A QNEC counts as a deferral in the ADP test. Thus, a QNEC can be used to correct a failed ADP test. A pro-rata QNEC would be allocated among NHCEs on the basis of compensation.

**A QNEC must be provided for in the plan document.** In addition, the allocation formula must be set forth in the document prior to the end of the plan year being tested. Many plans which contain QNECs will contain the "pro-rata" allocation formula set forth above. Keep in mind that the existence of QNEC language in a plan does not obligate the employer to make a QNEC in the event the ADP test is not satisfied. The employer retains the option of distributing amounts to HCEs.



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