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401(K) PLAN STRATEGIES: OPTIONS FOR ADDRESSING FAILED ADP TESTS

What is the ADP test?

The actual deferral percentage (or "ADP") test is an annual nondiscrimination testing requirement applicable to 401(k) plans. The test is conducted shortly after the end of each plan year based on the contributions ("deferrals") elected by each eligible employee during the year. If the plan fails the ADP test, appropriate corrective action must be taken.

How does the ADP test work?

The ADP test compares the average deferral rate (measured as a percentage of compensation) of eligible highly compensated employees ("HCEs") with the average deferral percentage of eligible non-HCEs. If the deferral percentage of HCEs exceeds the deferral percentage of non-HCEs by more than a specified margin, the ADP test is failed.

In general, the ADP for a plan's non-HCEs must not be less than two percentage points of the ADP of the HCEs. If the ADP of the non-HCEs is less than 2%, then the ADP of HCEs must not be more than two times the ADP of the non-HCEs.

Example 1: If the ADP for non-HCEs is 3.5%, then the ADP for HCEs must be less than 5.5%.
Example 2: If the ADP for non-HCEs is 0.8%, then the ADP for HCEs must be less than 1.6%.

What corrective actions can be taken to correct a failed ADP test?

A failed ADP test is typically corrected in one of two ways: (1) excess contributions are distributed from the accounts of HCEs and included as taxable compensation on the W-2s of the impacted employees; or (2) additional employer contributions are made to the accounts of non-HCEs in an amount sufficient to bring the non-HCE average deferral percentage up to a passing margin. Due to the expense of the second approach, most employers choose to correct failed ADP tests by distributing excess contributions to the plan's HCEs – resulting in an unwelcome tax hit to the impacted employees.

What strategies are available to help ensure that a 401(k) plan satisfies the ADP test?

The following strategies are available to increase the likelihood that a plan will satisfy the ADP test or otherwise mitigate the impact of a failed ADP test on the plan's HCEs:

SAFE HARBOR PLAN DESIGN

Summary: Special election that allows the plan to automatically pass ADP testing in exchange for a minimum, fully vested employer contribution.

Required Employer Contribution:

- 3% nonelective contribution for all eligible employees, whether or not they make deferrals under the plan; OR
- Matching contribution of 100% of each employee's deferrals up to 3% of compensation, plus 50% of each employee's deferrals between 3% and 5% of compensation (resulting in a total match of 4% of compensation for employees contributing 5% or more).

Pros:

A safe harbor plan automatically satisfies ADP testing. Thus, no more taxable distributions to HCEs.

Cons:

- Additional cost to fund the employer match.
- Safe harbor employer contributions are fully vested, so forfeitures will not be available to reduce contributions in future years.
- Annual notice requirements.

AUTOMATIC ENROLLMENT

Summary: Increase deferral percentage of non-HCEs by automatically enrolling eligible employees at a specified contribution rate unless the employee affirmatively elects to opt out of participation.

Additional Optional Safe Harbor: A plan that uses automatic enrollment can also elect the qualified automatic contribution arrangement ("QACA") safe harbor, provided that the employer makes a minimum employer contribution that can be slightly lower than the contribution required under a regular safe-harbor plan (total maximum match of 3.5% of compensation under a QACA versus 4% under a non-QACA safe harbor).

Pros:

- QACA safe harbor plans automatically satisfy the ADP test.
- Employer contributions under a QACA can be subject to a two-year vesting requirement.
- Even if the plan does not elect the QACA safe harbor, automatic enrollment can substantially boost participation rates by non-HCEs.

Cons:

- Additional administrative burden, including notice requirements.

CLASS EXCLUSIONS

Summary: Boost the non-HCE deferral percentage by excluding specified classes of employees with traditionally low contribution rates (e.g., seasonal, temporary, interns, etc.). Generally, a plan is permitted to exclude up to 30% of its non-HCEs.

Impact on ADP Test: The ADP test includes the deferral percentage of all eligible employees, including those with a deferral rate of zero. Employees in an excluded class are not included in the ADP test.

Pros:

- Can increase the deferral percentage of non-HCEs without requiring an increased employer contribution.

Cons:

- Additional coverage testing is required to ensure that the plan covers a sufficient percentage of the company's overall non-HCE workforce.
- Excluded employees lose a potentially valuable employee benefit.

NONQUALIFIED DEFERRED COMPENSATION PLANS

Summary: Separate and distinct from the 401(k) plan, a nonqualified deferred compensation ("NQDC") plan can be established to "capture" any taxable distributions to HCEs resulting from a failed ADP test.

Analysis: The NQDC plan would be set up to automatically transfer corrective distributions from a failed ADP test into an account under the NQDC plan (unless the HCE has elected not to participate).

Amounts credited to the NQDC account are not taxed until distributed to the HCE, typically upon termination of employment, death or disability. Earnings can be credited by mirroring the rate of return under the participant's 401(k) account.

Pros:

- Mitigates the tax impact of failed ADP tests on participating HCEs.

Cons:

- Employer is required to carry the cost of the NQDC plan on its books; no deduction is available until benefits are paid to the participants.
- Benefits under an NQDC plan are not fully protected and could be forfeited in the event of the company's insolvency.

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