

## **Understanding Your 401k Refunds for Highly Compensated Employees**

The 401(k) plan has emerged as the most popular form of retirement plan in the United States. This trend will likely continue for some time for a number of reasons. One is the cost savings to employers, since deferral contributions are paid by employees. Another is the fact that 401(k) plans are more easily understood than traditional retirement plans and consequently more appreciated by employees.

One aspect of 401(k) plans that is not so easily understood is the annual contribution nondiscrimination testing. This article will review the mechanics of this required testing and correction methods for failed tests.

### **Highly Compensated Employees**

Every 401(k) plan requires an annual test to prevent discrimination in favor of the group of employees referred to as "highly compensated employees" (HCEs). Employees who fall into the following two categories are considered to be HCEs:

- An owner of more than 5% of the employer in the testing year or the previous year (family stock attribution rules apply which treat an individual as owning stock owned by his spouse, children, grandchildren or parents), or
- An employee who received compensation in excess of a specified limit from the employer in the previous year (e.g., employees who earned more than \$100,000 in 2007 will be considered HCEs in 2008). The employer may elect that this group be limited to the top 20% of employees based on compensation.

### **401(k) Nondiscrimination Testing**

The nondiscrimination rules require average deferrals and average contributions for the HCE group to be within a certain range of the average deferrals and contributions for the "non-highly compensated employee" (NHCE) group.

Testing of employee deferrals is referred to as the ADP test (Average Deferral Percentage). The ACP test (Average Contribution Percentage) includes the employer match contributions, employee voluntary after-tax contributions and certain forfeitures allocated on the basis of deferrals or matching contributions.

Each participant's deferral or contribution percentage is determined by dividing the applicable deferral or contributions by the compensation defined in the plan document. Averages are then determined for the HCE and NHCE groups by dividing the sum of the deferral or contribution percentages by the number of employees in the group. Below is an example of the ADP determination:

<b>Employee</b>	<b>Compensation</b>	<b>Deferral</b>	<b>ADP</b>
HCE 1	\$200,000	\$12,000	6.00%
HCE 2	110,000	5,500	5.00%
HCE Total:			11.00%
<b>HCE Average (11.00% ÷ 2):</b>			<b>5.50%</b>
NHCE 1	50,000	2,000	4.00%
NHCE 2	40,000	2,000	5.00%
NHCE 3	30,000	0	0.00%
NHCE 4	20,000	800	4.00%
NHCE Total:			13.00%
<b>NHCE Average (13.00% ÷ 4):</b>			<b>3.25%</b>

The HCEs' average may only exceed the NHCEs' average (for both the ADP and ACP tests) by specific limits summarized as follows:

<u>NHCE Percentage</u>	<u>Maximum HCE Percentage</u>
2% or less	NHCE % x 2
2% - 8%	NHCE % + 2
more than 8%	NHCE % x 1.25

In the above example, the maximum ADP of the HCE group is 5.25% (the NHCE average of 3.25% plus 2%). The test fails since the ADP of the HCE group is 5.50% which is more than the 5.25% maximum.

In this circumstance, refunds would need to be made to bring the HCE group down to an average of 5.25%. As a simplistic example, the following distributions would need to be made:

<b>Employee</b>	<b>ADP</b>	<b>Adjusted ADP</b>	<b>Deferral</b>	<b>Adjusted Deferral</b>	<b>Refund Amount</b>
HCE 1	6.00%	5.72%	\$12,000	\$ 11,454	\$ 546
HCE 2	5.00%	4.77%	\$ 5,500	\$ 5,250	\$ 250

Therefore, the 2 HCE's above would get refunds to bring the plan into compliance. The participants will need to report the "Refund Amount" on their taxes, see below.

Catch-up contributions (available to participants who are age 50 or older if permitted by the plan) that exceed a statutory limit or plan-imposed limit are not included in performing the ADP test. Also, compensation for plan purposes is subject to an annual limit (\$225,000 for 2007 and \$230,000 for 2008). For example, assume Harry earned \$300,000 in 2007 and deferred \$20,500 (the maximum deferral of \$15,500 for 2007 plus the maximum catch-up contribution of \$5,000). His deferral percentage is calculated by

dividing \$15,500 (his deferral without the catch-up contribution) by \$225,000 (the compensation limit for 2007).

### **Correcting Test Failures**

Plans that do not pass the ADP and/or ACP tests must take some action, such as making corrective distributions.

### **Refund Deferrals/Matching Contributions**

The most common method used to correct a failed ADP or ACP test is to make corrective distributions of the excess deferrals or contributions, plus earnings (in some cases, forfeiture of matching contributions may be required).

Corrective distribution amounts (determined by a required leveling method) are allocated among the HCEs based on the dollar amount of their deferrals or contributions. If the plan permits catch-up contributions and the participant is 50 or older and has unused catch-up contributions remaining, the ADP refund is first offset by the unused catch-up contributions.

These distributions must be made within 2½ months of the plan year-end in order to avoid a 10% penalty (this deadline is extended to six months for plans that meet the eligible automatic contribution arrangement requirements). The final deadline for making corrective distributions with the penalty is the last day of the following plan year. For plan years beginning on or after January 1, 2008, these distributions are taxable in the year in which they are distributed (for plan years prior to 2008, distributions made before the 2½-month period are taxable in the prior year).

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