The Tale of Buffy, the ADP/ACP Slayer

Adriana M. Starr, Esq.

Buffy, the HR Director, is responsible for overseeing the company's retirement plan (the "Plan"), a calendar year 401(k) plan with discretionary matching contributions. Buffy receives an email on March 14, 2019, from Xander, the third-party administrator ("TPA"), with the retirement plan's annual compliance summary for 2018 and notification that the Plan failed the Actual Deferral Percentage ("ADP") and the Actual Contribution Percentage ("ACP") tests, the two nondiscrimination tests for 401(k)/matching plans. The email states that three highly compensated employees ("HCEs") should receive refunds from the Plan by March 15, 2019. Buffy fails to notice the instruction regarding the refunds and does not thoroughly review the annual compliance summary. The TPA did not follow up with Buffy regarding the refunds.

Buffy decides she is fed up with Xander's unreliability and unresponsiveness. (Buffy got him the testing data in mid-January, and was unhappy to receive the testing results with just one day to correct. Also, Xander put the Form 5500 on extension despite having the data so early.) Buffy hires Willow to replace Xander as the TPA in December of 2019. Upon receiving records from Xander in January of 2020, Willow quickly notifies Buffy about the refunds that were due by December 31, 2019.

What should Buffy do to correct the failed ADP and ACP tests for 2018?

ACP/ADP Correction Deadlines

Buffy needs to freshen up her understanding of the ACP/ADP tests and deadlines, so she knows how to avoid failures in the future. Each year, a non-safe harbor 401(k) plan must perform the ADP test and, if the plan provides a matching contribution, the ACP test. These tests are required to ensure that HCEs are not receiving a disproportionate amount of the benefit of the retirement plan compared to the nonhighly compensated employees ("NHCEs"). Failing the ADP/ACP tests is typically due to low participation or low deferral rates for NHCEs. If a plan fails the ADP/ACP tests, the employer has several options to make a timely correction so that the tests are deemed to pass.

2½ Month (March 15th for Calendar Year Plans) Deadline

The easiest and most common way (and, if the plan uses the prior year testing method, the only way) to correct failed ADP/ACP tests is to refund deferrals and either distribute to or forfeit from the HCEs the matching contributions that caused the tests to fail. Nonvested matching contributions are forfeited, rather than distributed. "Excess contributions" are deferrals made by HCEs that must come out of the plan to satisfy the ADP test. "Excess aggregate contributions" are the matching contributions allocated to the HCEs' accounts that must be removed from those accounts to pass the ACP test. Removing the excess contributions and excess aggregate contributions from the HCE accounts will reduce their average deferrals and matching contributions to the level needed to be in alignment with the contributions for NHCEs so that the tests are passed.

Optimally, distribution and/or forfeiture of these excess amounts for the affected HCEs should occur within 2½ months after the last day of the plan year to which the test applies. For calendar year plans, this is March 15. Plans that contain an eligible automatic contribution arrangement ("EACA") feature get the benefit of an extended deadline: they have until 6 months after the end of the plan year to distribute or forfeit the excess amounts.

Distribution/Forfeiture More Than 2½ Months After Year End

If the plan distributes or forfeits excess amounts more than 2½ months after the plan year (6 months for an EACA) but before the end of the following plan year, the failed ADP/ACP tests are still deemed to be timely corrected. However, the employer is required to file Form 5330 and pay an excise tax equal to 10% of all excess amounts before earnings.

As an alternative to making the corrective distributions and forfeitures of the excess amounts (and having the excise tax apply), Buffy has a second option to consider: the company may make a qualified nonelective contribution ("QNEC") or qualified matching contribution ("QMAC") by the end of the plan year following the year for which the testing is performed (i.e., by 12/31/2019 in our example). (The plan may use the refund/distribution option to correct one test and the QNEC or QMAC option to fix the other, so long as the correction yields a passing test.)

Regardless of which of these correction options is chosen, the ADP and ACP tests are considered to be timely corrected and there is no failure that threatens the plan's qualification.

How Do You Correct the Failure to Correct?

But, remember: in our situation, Buffy completely missed the December 31, 2019, deadline. Can she save the universe and maintain her reputation as an effective ADP/ACP test slayer? Never fear, EPCRS is here! Revenue Procedure 2019-19 ("EPCRS"), permits plans to correct the failure to distribute excess contributions and excess aggregate contributions before the 12-month deadline has passed, with the assurance that the correction will be accepted by the Internal Revenue Service in the event the plan is audited.

Plans may use two Self-Correction Program ("SCP") methods under EPCRS, if the plan has practices and procedures to keep the plan in compliance and the failure is corrected by the last day of the second plan year following the plan year for which the failure occurred. In this case, so long as Buffy corrects the 2018 ADP/ACP test by December 31, 2021 (two years after the normal deadline), she may self-correct. The Plan should document the correction thoroughly by having a memo on file along with calculations and proof of deposit. Under SCP, the plan may not use some of the more creative methods for testing, particularly disaggregation or the treatment of the plan as two separate plans. So, if the ADP/ACP tests were run using the "split test" or "otherwise excludable" methods (where participants who become eligible before completing one year of service and attaining age 21 are tested separately from the other employees), you have to throw that out the window. Corrective testing done after the deadline has to be done on an aggregated basis, so all of those beautiful zero percentages come into the correction, increasing the cost.

Option #1: QNEC/QMAC

If the QNEC/QMAC method is used to fix the failure, the correction is the same as what it would have been before the end of the 12-month period, although the company must also contribute interest on the QNEC or QMAC for the period between the original due date and the actual contribution. [EPCRS, Appendix A, Section .03] If this option is used, no adjustment is made to the HCE accounts and no excise tax needs to be paid.

Option #2: One-to-One Correction

Unfortunately, the refund/distribution method is no longer available in its original structure. A second version of this correction method, commonly called the "one-to-one" method under EPCRS, Appendix B, Section 2.01 is available. This method is the most often used, because it is less costly than the alternative QNEC/QMAC method.

The one-to-one QNEC method has two steps. First, the plan must refund excess contributions and distribute or forfeit the excess aggregate contributions, plus earnings. Second, the company must contribute a QNEC equal to the excess amounts and allocate it to the accounts of NHCEs pro-rata based upon compensation. So, if Giles, Dawn, and Tara need to receive $4,000 in total in refunded excess contributions and distributed excess aggregate contributions, the employer would need to fund $4,000 as a QNEC and allocate that amount to the NHCE accounts in proportion to compensation. The excise tax on excess contributions and excess aggregate contributions would apply to this correction, as they are removed from the plan more than 2½ months after the year of failure.

The plan has four options to determine the NHCEs who will receive QNEC allocation:

- NHCEs eligible in the year of failure
- NCHEs eligible in the year of failure and eligible in the year of correction
- NHCEs eligible in the year of failure who are employees on the date of correction
- NCHEs eligible in the year of failure and eligible in the year of correction who are employees on the date of correction.

Earnings for both the excess contributions and excess aggregate contributions must be calculated from the end of the plan year in which the failure occurred through the date of correction. The one-to-one deposit is for the amount of the excesses, plus the earnings. If there is a delay in making the deposit after the removal of the excesses, additional earnings should be determined on the deposit.

Going Forward

Buffy chose to keep the cost of the correction down and selected the one-to-one QNEC method. Buffy, with the help of Willow, appropriately put procedures in place to prevent the failure going forward and thoroughly documented the correction. Being a great TPA, Willow also sits down with Buffy and the company owners to discuss ways to avoid ADP/ACP testing entirely. With automatic enrollment, safe harbor 401(k) designs, and the new late adoption for the 3% safe harbor under SECURE Act, Willow can exceed the client's expectations and help Buffy save the day.

FERENCZY
BENEFITS LAW CENTER
We are your ERISA solution™

Ilene Ferenczy • ilene@ferenczylaw.com | Alison Cohen • acohen@ferenczylaw.com
Adrienne Moore • amoore@ferenczylaw.com | Adriana Starr • astarr@ferenczylaw.com
Tia Thornton • tthornton@ferenczylaw.com | Leah Dean • ldean@ferenczylaw.com

2635 Century Parkway Suite 200, Atlanta, GA 30345
T 404.320.1100 | F 404.320.1105 | www.ferenczylaw.com