Solving ADP Testing Failures: Many Ways to Skin a Cat

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Now that we are into the new year, retirement plan sponsors that found that their plan fell short in passing the required actual deferral percentage (ADP) test should think about taking appropriate action and following a proactive approach to plan design in order for this albatross to be lifted from their necks.

The government wants defined contribution plans to be nondiscriminatory so that these plans do not favor one group of employees over another. As a result, unfortunately, most companies have a select group of highly compensated employees who end up getting squeezed out of retirement savings at year-end, because the amount they can defer into the plan is directly attributable to the amount the nonhighly compensated participants (NHCEs) defer into the plan. This is what is known as the ADP test.

Under the ADP test, the average salary deferrals of the HCEs and NHCEs are calculated and compared on an annual basis based on the plan year. Each employee's deferral percentage is the percentage of compensation that has been deferred, pretax, to the 401(k) plan. The deferral percentages of the HCEs and NHCEs are then averaged to determine the ADP of each group. To pass the test, the ADP of the HCE group may not exceed the ADP for the NHCE group by 1.25 percent or two percentage points.

Many of these highly compensated employees (HCEs) are in their prime earning years yet they still are not allowed to properly fund for their retirement. Failing the ADP test results in refund checks being sent back to them for excess contributions. These participants will have to pay taxes on this money, which was once tax deferred. They will also lose the effect of compounding tax-deferred earnings on the amount refunded, which, over time, can be substantial. In the past this created a nightmarish situation for participants who already filed their tax return and now were required to submit an amended return. The good news is that recent legislation now allows these participants to claim these refunds as income in the year it was returned instead of the year it was deferred. But it is still an extra tax burden.

Plan sponsors have several tools at their disposal that can solve the problem or at least reduce the impact to their HCEs. These tools may require additional expense, time, plan amendments, and notifications, but in the end it may be a small price to pay to retain these key employees and keep them happy.

Employee Education

The one tool that does not require any additional expense or a plan design change is education. At many organizations, there is a large population of participants who are eligible but are not contributing to the plan. Most of the time these participants are NHCEs. Additionally, because of the market downturn, deferral percentages have decreased as many plans have eliminated or suspended matching contributions, only exacerbating the problem. A well-drafted, well-targeted education campaign run by your plan's advisor focusing on the importance of retirement savings and the impact of increased deferrals can go a long way in helping your NHCEs plan for their future. And by it boosting the NHCEs' contributions, it can help alleviate the ADP problem and help your HCEs set aside more dollars for a properly funded retirement.

Safe Harbor 401(k) Plan

Employers looking for immediate results that do not mind buying their way out of this dilemma can adopt a safe harbor plan. By amending a plan to include the safe harbor provision, employers automatically satisfy the nondiscrimination testing. Most important, this allows HCEs to save up to the maximum limit. A safe harbor 401(k) requires that an employer make either a contribution of three percent of compensation or a matching contribution (for example, 100 percent of the first three percent contributed and 50 percent on the next two percent). Additionally, this contribution must be 100 percent vested, the employer must send out an annual notice and this source may be