We Failed the ADP Test! What Did We Do Wrong & How Do We Fix It?

Facts

Our TPA just sent us our annual compliance report, and it says we failed testing! This is the first year we've failed anything, and now we're being told that we need to take money out of the plan in order to remedy the failure. I don't understand why this is happening.

Question

What on earth did we do wrong to cause the plan to fail? Why did the ADP test fail? What do I need to do to fix it?

Answer

For starters, failing the ADP test does not mean you did something wrong. In fact, from one perspective, it can actually be a sign that the company's highly compensated employees (HCEs are generally company owners and those earning more than $125,000 per year) received the maximum advantage of the plan. More on that later; first let's quickly review how the ADP test works.

ADP Test Recap

The ADP test is one of many nondiscrimination tests that must be performed each year to ensure the plan does not disproportionately favor HCEs over non-HCEs by comparing the average deferral rates of each group. While there are some nuances, the general rule is that in order for the plan to pass the test, the HCE average cannot exceed the NHCE average by more than two percentage points.

Potential Reasons for Failure

So, why would you go from usually passing the test to failing it? The most common reason is a change in the composition of your group of participants.

For example, maybe you have a non-HCE participant who is deferring at a significant rate who terminates employment. Removing that high deferral rate from the non-HCE group reduces that group's average, which could cause the test to fail. On the flipside, maybe the owner of the company has a child that comes to work and defers into the plan at a very high rate. Because company ownership is attributed to certain family members, that child is treated as an owner and HCE, pushing the average HCE deferral rate out of the passing range.

Of course, there are other financial factors that can come into play, leading to a similar result. Maybe a non-HCE must scale back 401(k) deferrals because a child's college tuition bill is due. Conversely, maybe an HCE just finished paying off student loans and is ready to ramp up 401(k) deferrals. Basically, anything that pushes the average contribution rates further apart has the potential to cause the plan to fail the ADP test. Anything that pulls the averages closer together improves the test results.

That is what we were referring to when we mentioned that a failed ADP test indicates that HCEs are getting as much as possible out of the plan. The HCEs could decide to scale back their contributions in an effort to achieve a passing test. However, if they over-compensate, then they are receiving less of a benefit than they could have. A failing test means they, as a group, could not have received a penny more.

The Fix Is In

The good news is that there is no penalty for failing the ADP test as long as timely corrections are made.

If the spread between the HCEs and non-HCEs is more than two percentage points, the company must close the gap by:

- Contributing more to the non-HCEs (to boost their average),
- Issuing refunds from the plan to the HCEs (to reduce their average), or
- Some combination of both.

Most plans elect to refund the excess deferrals to the HCEs to avoid dipping into the company pocketbook to fund additional employer contributions, but that is a decision that is up to each individual company.

So, what does "timely" mean? We're glad you asked, and like almost every question in the 401(k) world, it depends.

The outside deadline to make timely correction of a failed ADP test is the last day of the following year. For example, if a calendar year plan fails the test for the 2018 plan year (performed in early 2019), correction must be completed no later than December 31, 2019. Go beyond that date, and the fix becomes much more involved (and expensive) and must often be sent to the IRS for their review and approval.

If you elect to correct by making refunds to the HCEs, there is another important deadline to keep in mind. It is two and a half months following the close of the year of the failure. Continuing our above example, that would be March 15, 2019. Refunds must be completed by that date in order to avoid a an excise tax equal to 10% of the refund amount, payable by the company (not the plan or participants) to the IRS. The excise tax only applies if correcting via refund; if you are correcting by making additional contributions to non-HCEs, December 31st is the deadline to watch.

Looking Ahead

Correcting a test failure is a requirement in order to preserve the plan's tax benefits; however, it may be possible to change how the plan is designed to prevent failures in future years. Examples might include changing how the test is performed to make the results more predictable to building in certain features to "buy your way out" of the test altogether.

If you would like assistance reviewing options to improve your test results, give us a call. For more information on nondiscrimination testing in general and the ADP test more specifically, please visit our Knowledge Center here and here.

Related Resources

- [Nondiscrimination Testing Overview]
- [Who are Highly Compensated & Key Employees?]
- [Attribution of Ownership FAQs]
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