Corrective distributions

OVERVIEW

The Internal Revenue Service (IRS) requires qualified 401(k) retirement plans to perform compliance testing (also referred to as Non-Discrimination testing) on an annual basis to determine whether all participants are benefiting equitably from the plan. Plan benefits of highly compensated employees (HCEs) and key employees are compared to plan benefits of non-highly compensated employees (NHCEs). As a result of this testing, excess contributions may be discovered resulting in the need for corrective distributions.

NOTE: Plans administered by a Third Party Administrator (TPA) direct Empower to process corrective distributions by completing Empower's Corrective Distribution Request Form, authorized by plan signer or authorized TPA.

The four most common components of Non-Discrimination testing that may result in corrective distributions are outlined below.

Actual Deferral Percentage (ADP) Test

The ADP test determines if the average contribution rates of HCEs exceeds the average contribution rates of NHCEs by more than a prescribed amount.

Limit testing

- Ensures IRS contribution limits are enforced.
- Catch-up contributions are exempt from certain limitations.
- Loan payments and rollover funds are not included in limit testing.

Actual Contribution Percentage (ACP) Test

The ACP test is conducted in the same manner as the ADP test but includes employer matching contributions and after-tax contributions in calculating contribution rates.

Ineligible contributions

- Employee contributions made to the plan prior to have met eligibility requirements of the plan, such as minimum age and service.
- Employee's contributions and earnings, if any, must be returned to the participant. Any employer money contributed is forfeited.

Deadlines and timelines

- Non-Discrimination tests are performed annually based on the plan year.
- Clients avoid a 10% excise penalty if testing and corrections (including corrective distributions) are completed no later than 2 ½ months after plan year end. Certain plans with Eligible or Qualified Automatic Contribution Arrangements (EACA or QACA) have a 6 month ADP/ACP deadline.
- Excess contributions are considered taxable in the year the excess occurred.
- Ineligible contributions, including any applicable earnings, returned to the employee are taxable in the year of distribution and reported on a 1099-R sent to the participant in the following year along with a letter of explanation.
- NOTE: See Federal 401(k) and 401(a) Provisions for further information.

How it works

Client

Receives compliance testing results notification via email from Empower:

- Reviews testing results on the Compliance To Do list within the Plan Service Center (PSC).
- Overrides participant's default vested percentage and default tax withholding, if applicable.
- Electronically submits the corrective distribution request for processing.
- NOTE: If the plan is administered by a TPA, the TPA completes the Empower Corrective Distribution Form and submits to Empower, at the Client's direction.

Empower

Receives and processes the Empower Corrective Distribution Form or online submission:

- Calculates earnings/losses associated with the amount being distributed as of the day the corrective distributions are processed.
- Produces tax forms and reports distributions for the applicable tax year.
- Sends distribution checks along with letters of explanation to participants.
- NOTE: If a participant has fully distributed or rolled their full balance prior to processing the corrective distribution request, the 1099-R representing the full withdrawal is reduced by the excess amount and a new 1099-R is issued for the excess. A "Zero Balance Letter" will be sent to the participant explaining the change.

Participants

- Override default tax withholding by electing any percentage for federal and state tax withholding, if preferred.
- Receives check with letter of explanation.
- Receives 1099-R tax reporting form.
- NOTE: If participant receives a "Zero Balance Letter", the letter includes additional instructions regarding actions the participant may need to take to correct the full withdrawal previously taken.