

ALSTON + BIRD_{LLP}
EMPLOYEE BENEFITS &
EXECUTIVE COMPENSATION ADVISORY

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401(k) Plan Administrators Beware the Ides of March — Should They?

We frequently speak with clients who believe that, if their 401(k) plan fails the ADP or ACP test, refunds to highly compensated employees must be issued by March 15. This is not quite true, and understanding the entire truth will lead many plan administrators to a different, better course of action.

If a plan fails the ADP or the ACP test, there are at least three ways to solve the problem, and often times more than three.

1. Refund contributions to highly compensated employees *after March 15*.¹ The employer will pay a 10% excise tax on the amount refunded. The amount refunded is taxed to the employees in the year of distribution (2008, for refunds issued after March 15, 2008).
2. Refund contributions to highly compensated employees *on or before March 15*. The employer pays no excise tax, but the employee is taxed on a portion of the refund in 2007. Thus, some highly compensated employees may end up having to file amended tax returns, at considerable expense, trouble and aggravation.
3. Contribute a qualified non-elective contribution (“QNEC”) for non-highly compensated employees. This is often the most cost-effective solution. We recently had a client solve an ADP test failure by making a QNEC of only one-fortieth of the amount that would otherwise have had to be refunded. (However, please note that the results for a QNEC are not always that good, and a QNEC is not always the most cost effective option.) The QNEC can be made as late as December 31, 2008. If an amendment is required to permit the QNEC, the amendment can be made as late as October 15, 2008.
4. Change the testing method. This doesn’t always work, but it is surprising how often it does work. The plan administrator can make a number of elections as to how to perform the ADP and ACP tests — for example, what definition of compensation to use, which plans to aggregate, whether to test by qualified separate lines of business, etc.

Here is the key point: if you simply issue refunds because the March 15 “deadline” leaves you no time to consider alternatives, you may miss your best option. In our experience, many clients prefer to issue refunds after March 15 and pay the 10% excise tax rather than aggravate their top employees by forcing them to amend their tax returns.

Note that March 15 is a Saturday this year. The deadline, if you want to issue refunds and want to avoid the excise tax, is March 15. Some tax deadlines are extended to the following Monday; this one isn’t.

¹ All dates in this advisory assume the plan year is the calendar year.

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The rules will change in 2009. Refunds for the 2008 plan year that are made in 2009 will be taxed in 2009, whether they are issued before or after March 15. Also, for some plans, the deadline for issuing refunds without an excise tax will move to June 30.

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