

Corrective Refunds

Refunds Needed to Pass Tests and Comply with Plan Limits



Retirement plans are required to perform tests each year to ensure compliance with certain laws and limits. When a plan is out of compliance, one solution may be to pay out a Corrective Distribution. These are refunds paid out by a plan when an employee exceeds a limit or a plan fails a required test.

What are the types of corrective refunds?

There are several reasons a plan may need a corrective refund from the plan. Below are common reasons:

- **Failed ADP or ACP Test** - The #1 issue leading to a corrective refund arises when a plan fails the ADP or ACP Test required for traditional 401(k) plans (not "safe harbor 401(k) plans).
- **Excess Deferral** - Another common reason a plan may need to pay corrective refunds is when a participant contributes more than the annual deferral limit (referred to as the IRC Section 402(g) limit). This limit is currently \$23,000 with an additional \$7,500 for participants over age 50. \$11,250 for those turning 60, 61, 62, or 63 in 2025.

What is an ADP Test refund?

The ADP Test compares the deferral rates of the Highly Compensated Employees (HCEs) to the rates of the Non-Highly Compensated Employees (NHCEs). When these rates exceed allowable differences, the plan can get back into compliance by paying Corrective Distributions to the HCEs.

What is an ACP Test refund?

The ACP Test compares the matching rates of the HCEs to the rates of NHCEs. When these rates exceed allowable differences, the plan can get back into compliance by paying Corrective Distributions to the HCEs.

Highly Compensated Employees generally include owners and employees making above a salary limit (\$135,000 for 2023 and \$150,000 for 2024)

and may also include certain family members of owners employed at the company.

Can a 402(g) Refund be Avoided?

If an employee exceeds the annual 402(g) limit, they are required to take a corrective distribution from the plan to stay within allowable limits. To avoid 402(g) refunds, Deferral Limits must be monitored closely by the plan's payroll provider.

Can ADP / ACP Refunds be Avoided?

To minimize ADP / ACP Refunds:

- Consider Safe Harbor 401k plans,
- Consider Automatic Enrollment and Escalation,
- Consider Employee Enrollment and Education Meetings
- Consider Whether Raising Match would increase Participation

When are Corrective Refunds Processed?

ADP or ACP refunds are identified and processed after the plan's year-end. If these are paid out within 2 ½ months no penalties apply. After 2 ½ months a 10% employer paid penalty applies. These distributions must be processed within one year following plan year-end.

Section 402(g) refunds may be processed as soon as they are identified, even before plan year-end. These refunds must be processed by the next April 15th. If they are processed later, the employee / participant is required to pay tax twice on the Excess Deferral.

What are the tax consequences for the participant?

Corrective refunds plus investment earnings are taxable to the participant when distributed.

Please contact JULY at [888.333.5859](tel:888.333.5859) for more information.