401(k) Refund - What Can Be Done?

401(k) REFUNDS

At some point, highly compensated employees (HCEs) may find themselves in receipt of a refund check for what is determined to be "excess" 401(k) contributions. It is an unfavorable situation for both plan sponsors and highly compensated plan participants. These refunds are expensive to process, time consuming and require significant communication and education to impacted employees.

WHY DOES THIS HAPPEN?

How could a refund be a bad thing? Each year, participants contribute to 401(k) plans, assuming that the money deposited will grow tax deferred and accumulate for retirement. Qualified plan nondiscrimination testing can potentially put a halt to this.

ERISA requires that all 401(k) plans (except safe-harbor plans) pass annual nondiscrimination testing. In order to pass, plans may need to refund what is determined to be "excess" contributions. It is a no-win for employers and HCEs—recipients will owe more income tax for the current tax year, and may forfeit some of the company matching dollars while employers are at risk of fines and a potential loss of qualified plan status.

WHAT CAN BE DONE?

- Encourage non-HCEs to participate more and at higher contribution levels—this may result in additional costs for the plan sponsor through: 1.) increasing the company match cost and/or 2.) significantly increasing communication costs.
- Change to a safe harbor plan design – this will typically result in a significant cost increase for the plan sponsor
- Further restrict 401(k) contributions for HCEs or make HCEs ineligible for the 401(k)—this hurts the HCEs who are already limited by the amount that can be saved for retirement
- Redirect employee contributions into after-tax savings plan—this is also less efficient for retirement savings and doesn't typically solve the entire problem

WHAT IS A BETTER SOLUTION?

What if checking a box could help solve this problem? If elected prior to the start of each calendar year, potential 401(k) refunds can be deferred on a pre-tax basis with tax deferral on investment gains. This results in the same tax treatment as other pre-tax 401(k) deferrals, and ultimately doesn't penalize the employer or employee.

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Include excess 401(k) contributions as an eligible compensation source and election in your Deferred Compensation Plan

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