



OFFICE OF THE CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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The Honorable Mark R. Warner
United States Senate
Washington, DC 20510

Dear Senator Warner:

I am responding to your inquiry dated February 6, 2014, on behalf of your constituent, _____ works at a small business with 10 to 15 employees and said that he attempts to maximize his annual 401(k) plan contributions, but because he is a highly compensated employee and no other employees contribute to the plan, the plan refunds his contributions to avoid failing the nondiscrimination requirements. He asked why the law discourages retirement savings and asked you to consider changing it.

_____ appears to be describing the plan's annual actual deferral percentage (ADP) test. The ADP test is a nondiscrimination test that compares the average salary deferrals made by the group of highly compensated employees (HCEs)¹ covered by a 401(k) plan to the deferrals made by nonhighly compensated employees (NHCEs). The ADP test is generally satisfied if either:

- The average salary deferrals the HCEs make are not more than 125 percent of the average salary deferrals the NHCEs make, or
- The average salary deferrals the HCEs make are not more than 2 percent higher than the average salary deferrals the NHCEs make [Section 401(k)(3)(A)(ii) of the Internal Revenue Code (Code)].

A plan that fails to satisfy the ADP test could lose its tax-qualified status, which would have adverse tax consequences for all plan participants. However, a plan may preserve its tax-qualified status by correcting the failure in one of several ways, including distributing the excess deferrals to the HCEs [Section 401(k)(8) of the Code].

¹ In 2014, a highly compensated employee is generally an employee who is a 5-percent owner or earns at least \$115,000.

The Congress designed these nondiscrimination requirements to ensure that “the special treatment of elective deferrals is not available unless the 401(k) plan does not disproportionately benefit highly compensated employees” [House Conference Report 99–841 (Volume II), at II–381 (1986), 1986–3 C.B. (Volume 4) 1, 381].

I hope this information is helpful. If you have any questions, please contact me at () or at () .

Sincerely,

Victoria A. Judson
Division Counsel/Associate Chief Counsel
(Tax Exempt and Government Entities)