

401(K) PLAN NONDISCRIMINATION TESTING

In order to ensure a 401(k) plan is not favoring owners or highly paid employees, the IRS requires certain nondiscrimination testing is performed. The Actual Deferral percentage Test (ADP) measures the employee deferral contributions and the Actual Contribution Percentage Test (ACP) measures the employer matching contributions. ADP/ACP testing must be completed annually.

Both tests take the *average* contribution rates of the Highly Compensated Employee (HCE) group of participants and compare to the *average* contribution rate of the Nonhighly Compensated Employee (NHCE) group of participants.

WHO ARE HIGHLY COMPENSATED EMPLOYEES (HCE)?

The IRS defines a HCE as an owner of **more than** 5% of the company in the current or previous plan year or an employee who received compensation in excess of an indexed compensation limit in the previous plan year. The IRS adjusts the compensation limit annually for cost-of-living increases. Family attribution rules treat a spouse, child, parent or grandparent of someone who is a 5% owner as an HCE, regardless of that individual's compensation or ownership. If the plan document allows, HCEs can be limited to the top-paid 20% group of employees when ranked by pay. Employees may move from the HCE group to the NHCE group (and vice versa) in different plan years, so the classification of employees is determined annually.

PASSING ADP/ACP TESTING

In order to pass the tests, the HCE average contributions (deferrals or match) must be within a certain percentage of the average contributions of the NHCEs (usually within 2%). To run an ADP/ACP test, each eligible participant's total **contribution** is divided by his **compensation** as defined in the plan document. The individual contribution ratios are then averaged for the separate HCE and NHCE groups. It is important to note that employees who are eligible but not contributing are included in the calculations with a 0% ratio which lowers the average percentage for that group. The ADP test does not include catch-up contributions.

CORRECTING A FAILED TEST

1. Return the excess contributions, including earnings, to HCEs. The distributions are first made to HCEs who deferred the highest dollar amounts, not the highest percentage, lowering the average percentage contribution until the test passes. The return of excess amounts must be done within 2½ months of the close of the plan year to avoid an IRS excise tax of 10%. The corrective distribution amount returned is taxable to the participant in the calendar year in which the distribution is received and a Form 1099-R is issued for tax reporting.
2. The employer makes an additional fully vested contribution. The contribution must be sufficient enough to increase the average rate of the NHCE group to the level needed to pass the ADP and/or ACP test.

WHAT A FAILED ADP/ACP TEST MEANS

401(k) plan nondiscrimination testing is complex. Many financial advisors and plan sponsors want to maximize deferrals for the Highly Compensated Employee (HCE) group, yet feel stressed (and even panicked!) at the thought of failing the ADP/ACP testing.

Failure is defined as a lack of success so, we get it, no one likes to fail. But, it's important to remember that the goal of a 401(k) plan is to provide your employees with an opportunity to save the maximum amount legally allowed for retirement. The reality is, when your plan passes ADP/ACP testing, your HCE group probably could have contributed more than what they did, so they miss out deferring those additional savings. On the other hand, a failed test means your HCE group was able to defer the maximum amount legally allowed. You should really view this excess as an overage and not a failure, since the "failed" test means you **succeeded** in maximizing the HCE deferrals into the plan during that year.

It's also important to remember that a failed test does not signal your plan for an IRS/DOL audit. It merely indicates that the HCE group contributions were disproportionately larger than the NHCE group. As long as you correct the failure in a timely manner, your plan remains in good standing with the IRS/DOL.

However, before you toast to a failed test, it's still important to analyze *why* the test failed. For example, if the ADP test failed due to poor participation from the NHCE group, then strategies can be discussed with your Third Party Administrator (TPA) to increase NHCE participation, such as implementing an automatic enrollment feature. By increasing the NHCE participation, you will increase the amount the HCE group can defer.

Several strategies can be discussed with your TPA. For example, a mid-year test can be used to estimate if the plan is going to pass or fail ADP/ACP testing for the year. This snapshot provides the opportunity to discuss the results with your TPA to determine if your plan is optimized for your participants or if changes should be considered. You can also discuss adding a safe harbor feature to the plan, which eliminates the need for ADP/ACP testing.

Contact your Watkins Ross Retirement Plan Administrator to discuss testing solutions to optimize your employee retirement savings.