Compliance Testing

THE BASICS

Your 401(k) plan must be examined regularly to confirm that it is in compliance with the tax code and ERISA regulations. The primary purpose of this compliance testing is to ensure that the 401(k) plan does not discriminate in favor of Highly-Compensated Employees. The tests include non-discrimination testing (also known as anti-discrimination testing) and top-heavy testing.

For smaller companies a "safe harbor" 401(k) plan allows the plan to bypass anti-discrimination testing, as long as the company contributes an amount equal to approximately 3% to 4% of each employee's compensation. Beginning in 2002, a safe harbor matching or non-elective contribution was also deemed to satisfy top-heavy requirements.

Non-Discrimination Testing

The purpose of non-discrimination testing is to prevent senior executives and business owners from benefiting disproportionately from the 401(k) plan. This consists of two tests:

- Average Deferral Percentage test (ADP test)
- Actual Contribution Percentage test (ACP test)

Both these tests measure the contribution rates of two groups of employees: the Highly-Compensated Employees (HCEs) and the Non-Highly-Compensated Employees (Non-HCEs).

- An HCE is defined as an employee who (a) in the current or previous plan year is more than a 5% owner or (b) earned more than $95,000 during the previous twelve months and, if the employer elects, is in the top 20% of employees by compensation for that year.
- All other employees are considered Non-HCEs.

ADP/ACP testing is usually performed once or twice a year, depending on your plan's administrative service agreement. ADP tests measure only participant pre-tax salary deferrals into the plan, while ACP tests measure the percentage of employer qualified matching contributions and qualified non-elective contributions made on behalf of each participant.

Generally, the average percent contributed by and to HCEs cannot exceed certain limits based on the average percent contributed by and to the Non-HCEs in the current or preceding year.[1] That is, whatever the Non-HCEs contribute as a group on average determines how much the HCE group's average contributions can be. While the basis for the ADP and ACP tests are different, the rules are the same. Thus, a plan will pass the ADP/ACP testing if either of the following standards are met:

- Average deferrals for the HCEs do not exceed 1.25 times that of the average deferrals for the Non-HCEs.

OR

- Average deferrals of HCEs do not exceed the lesser of (a) two percentage points above or (b) two times the deferrals of Non-HCEs.

1 Using current year data is an election, and must be consistent from year to year.

ADP QUICK REFERENCE GUIDE

If the ADP of the Non-HCEs is:	The maximum for HCEs is:
0–2%	2 times that percentage
3–8%	Stated percentage PLUS 2 percentage points
> 8%	1.25 times the Non-HCE percentage

Non-HCEs Percent Contribution	HCEs Maximum Percent Contribution
0	0
1	2
2	4
3	5
4	6
5	7
6	8
7	9
8	10
9	11.25
10	12.50

Example:

Let's look at a hypothetical example of anti-discrimination testing. Smith Service Company has seven eligible Non-HCEs and three eligible HCEs.

	Compensation	*Salary Deferral*[2]	*Deferral Percentage*
Non-HCE #1	$35,000	$3,150	9%
Non-HCE #2	$25,000	$1,000	4%
Non-HCE #3	$40,000	$2,400	6%
Non-HCE #4	$43,000	$ 0	0%
Non-HCE #5	$54,000	$4,320	8%
Non-HCE #6	$30,000	$1,500	5%
Non-HCE #7	$28,000	$ 840	3%
Average Non-HCE Deferral Percentage			*5%*
HCE #1 — 50% Owner	$ 10,000	$1,500	15%
HCE #2 — 50% Owner	$100,000	$3,000	3%
HCE #3	$150,000	$4,500	3%
Average HCE Deferral Percentage			*7%*

In this example, Smith Service Company would pass the ADP test, because the 7% average HCE deferral does not exceed the 5% average Non-HCE deferral by more than the 2-point margin.

Note: Catch-up contributions (available to participants aged 50 and over) are not included for testing purposes.

2 Keep in mind that pre-tax salary deferrals are limited to $14,000 per participant in 2005 and $15,000 in 2006, with possible cost-of-living adjustments after 2006.

What if my plan fails the ADP/ACP tests?

There are several recourses available to a plan sponsor when a plan fails the ADP or ACP test. The first is to contribute something to the plan on behalf of *Non-HCEs only*. This is called a "qualified non-elective contribution," or QNEC, and would be given to Non-HCEs on a pro rata basis to increase their averages as a group.

Employers may also make a "qualified matching contribution," or QMAC. A QMAC is a matching contribution made based on a participant's elective contributions to the plan. Any contributions made as QMACs or QNECs are immediately vested — that is, this money is the employee's to control and keep.

Another option would be to return some of the contributions made by the HCEs. This involves a complicated process that should be discussed with your plan administrator in the event that your plan fails the test. This is generally a less desirable choice, as it could generate adverse tax consequences for affected participants.

Top-Heavy Testing

A retirement plan is considered to be top-heavy when the combined plan assets of the **key employees** total 60% or more of the plan's total assets. You can gauge whether or not your plan is top-heavy by evaluating the assets of the plan for the current or prior ("look back") year.

Determine who is a key employee and who is not using the following rules. An individual is generally considered to be a key employee if at any time during the current plan year he or she was:

- An officer of the company with annual compensation in excess of $130,000.
- One who owns greater than 5% of the business, or a family member of a 5% owner.
- One who owns greater than 1% of the business and earns more than $150,000 a year.

All other employees are considered **non-key employees**.

What if my plan fails the top-heavy test?

If your plan is found to be top-heavy, you may be required to make some minor modifications, including:

- **Speeding up the vesting schedule.** For example, if a plan with a six-year vesting schedule is deemed to be top-heavy, participants will be subject to a "faster" vesting schedule. The faster vesting schedule would only apply in years that the plan is top-heavy.

– or –

- **Making nominal contributions to the non-key employees.** In general, the minimum contribution is 3% of non-key employees' salaries.

Note that if you have more than one plan, all plans are combined for testing purposes. If the combined plans are top-heavy, the minimum modifications must be made to at least one plan.

Safe Harbor 401(k) Plans

Discrimination testing is expensive and time-consuming, and some employers may consistently experience problems keeping their plans in compliance. Employers seeking to avoid these difficulties may want to consider a "safe harbor" 401(k) plan. In exchange for being exempt from non-discrimination testing, safe harbor plan sponsors must make matching contributions or non-elective contributions. All safe harbor contributions are fully and immediately vested to the participants.

- Designated matching contributions must provide for a 100% match on the first 3% of all NHCEs' compensation, and an additional 50% match on the next 2% of any elective contributions.
- Non-elective contributions require the employer to make a contribution for *all eligible participants* — including those who do not opt to make 401(k) salary deferrals — equal to 3% of their salaries.

A safe harbor plan that incorporates either a matching contribution or a non-elective contribution will be deemed to satisfy ADP/ACP and top-heavy testing.

Who might benefit most from a safe harbor plan?

While there is no one-size-fits-all answer regarding 401(k) plans, a safe harbor 401(k) plan may be a good alternative for many plan sponsors, particularly in the following situations:

- Employers who are planning to or who already make a comparable matching contribution.
- Employers whose plans are top-heavy (at least 60% of plan assets are in the accounts of key employees).
- Employers with relatively low employee turnover.
- Companies with fewer employees (where a large percentage are defined as "key employees").
- Companies whose HCEs are interested in contributing more to the plan and whose elective deferrals would be or have been significantly limited.
- Companies seeking to limit the time and money spent on plan testing.

Important

Please be aware that while this handbook covers the most commonly asked-about compliance tests, there are additional tests required for your 401(k) plan, including tests related to Sections 410(b), 402(g), and 415 of the tax code, and a limit on plan compensation under Section 401(a)(17) of the tax code. Please consult a qualified advisor or your plan administrator regarding these tests and limits.

Age-Weighted and New Comparability Profit Sharing Plans

Age-weighted and New Comparability profit sharing plans may provide a desirable alternative for small companies (typically under 50 employees) with an owner closer to retirement age than the majority of the employees. These plans may allow the owner to maximize personal contributions while minimizing plan costs, and provide the owner with the flexibility to allocate discretionary contributions in their favor and that of key personnel.

Age-Weighted: allows employers to allocate a greater percentage of profit sharing contributions to older employees, under the logic that they have less time to save, using a formula that converts contributions to equivalent benefits at retirement. In order to satisfy nondiscrimination rules, the formula, as defined in the plan document, must produce the contribution required to generate at a participant's normal retirement age an annuity benefit equal to 1% of compensation.

			Pro Rata		Age-Weighted	
Participant	*Age*	*Compensation*	*Contribution*	*% of Compensation*	*Contribution*	*% of Compensation*
Owner	49	$200,000	$40,000	20.0%	$40,000	20.0%
Employee 1	35	$80,000	$16,000	20.0%	$5,106	6.3%
Employee 2	32	$40,000	$8,000	20.0%	$1,999	5.0%
Employee 3	28	$35,000	$7,000	20.0%	$1,262	3.6%
Employee 4	29	$30,000	$6,000	20.0%	$1,173	3.9%

These numbers are for illustrative purposes only. Actual results may vary.

New Comparability: divides employees into two or more groups on the basis of objective standards. A greater percentage of profit sharing contributions is allocated to one group (e.g. “the owner”) vs. the other group. A complex formula then converts those contributions into a future benefit for testing purposes. Because of the allocation flexibility of this type of plan, it is subject to stringent discrimination tests. Additionally, changing employee demographics throughout the year may impact the groups and their contribution rates.

			Pro Rata		New Comparability	
Participant	*Age*	*Compensation*	*Contribution*	*% of Compensation*	*Contribution*	*% of Compensation*
Owner	49	$200,000	$40,000	20.0%	$40,000	20.0%
Employee 1	35	$80,000	$16,000	20.0%	$4,000	5.0%
Employee 2	32	$40,000	$8,000	20.0%	$2,000	5.0%
Employee 3	28	$35,000	$7,000	20.0%	$1,750	5.0%
Employee 4	29	$30,000	$6,000	20.0%	$1,500	5.0%

These numbers are for illustrative purposes only. Actual results may vary.