Understanding Nondiscrimination Testing

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Nondiscrimination Testing

Nondiscrimination testing is the process of identifying when benefit limits for qualified retirement plans are exceeded. Essentially, nondiscrimination regulations were created in order to prevent retirement plans from discriminating in favor of Highly Compensated Employees (HCEs).

Nondiscrimination testing falls into four categories:

- Compliance Testing (ACP/ADP)
- Sections 402(g) and 415 Limitation Testing
- Top-Heavy Testing
- Minimum Coverage & Participation Testing

The rules governing each type of test work together as an interrelated package. Testing is performed on an annual basis to ensure that qualified plans continue to fall within Internal Revenue Service (IRS) guidelines.

A Long-Term Approach To Testing

Nondiscrimination testing has often been looked upon as a short-term arithmetic problem that can be remedied each year. By understanding how plan design can impact testing you can take advance planning steps to minimize both the uncertainty and the consequences of the testing process.

Pentegra provides the consulting support needed to address plan design issues. Short-term strategies such as preliminary nondiscrimination testing during the plan year can also be employed in order to detect and prevent problems at plan year-end.

By employing these strategies, Pentegra helps ensure that your plan continues to fall within IRS guidelines, while still meeting overall compensation and benefit objectives.

In order to determine if a plan discriminates in favor of HCEs, two tests must be performed, the Actual Deferral Percentage (ADP) test which tests 401(k) contributions and the Actual Contribution Percentage (ACP) test which tests after-tax and employer matching contributions. These tests are designed to limit the extent to which contributions made by or on behalf of HCEs may exceed the contributions made by or on behalf of Non-Highly Compensated Employees (NHCEs).

Defining Who Is Highly Compensated

HCEs are generally defined as:

- A 5% owner of the employer in either the prior year or current year
- An employee earning in excess of $120,000 in the previous plan year, per 2017 HCE limits.

Performing Compliance Testing

Compliance testing requires that the contributions made by or on behalf of all eligible HCEs be compared to that of all eligible NHCEs. Both non-401(k) and 401(k) contributions must be tested separately. It is possible to satisfy one test and not the other.

Testing Non-401(k) Contributions

The Actual Contribution Percentage, or ACP, test applies to employer matching contributions and employee after-tax contributions, (if any). The ACP for both HCEs and NHCEs is determined by calculating the contribution percentage for each individual participant in the group, adding these percentages together, and dividing the total by the number of members in the group. The ACP of the HCEs must fall within an acceptable limit, a determination of which is based on the ACP of the NHCEs. When performing compliance testing, all eligible employees, regardless of whether they are actually contributing to the plan, are taken into consideration.

Testing 401(k) Contributions

The Actual Deferral Percentage, or ADP, test applies to 401(k) contributions. The ADP is determined in the same manner as the ACP. A separate application of the same test is made to determine if the ADP of the HCEs falls within the limit as determined by the ADP of the NHCEs.

Testing Requirements

The Plan will satisfy the separate ACP and ADP rules if, on the last day of the plan year, one of the following tests is satisfied:

1.25% Test

The ACP/ADP of the highly compensated group cannot be more than 1.25 times the ACP/ADP of the non-highly compensated group;

OR

2 Times/2% Test

The ACP/ADP of the highly compensated group cannot be more than 2 times the ACP/ADP of the non-highly compensated group, or the ACP/ADP of the highly compensated group cannot be more than 2 percentage points higher than the ACP/ADP of the non-highly compensated group. The lesser result of these two tests is applied.

For HCEs, the amount deferred or contributed is based on current plan year data. Employers have the option to use prior year data for NHCEs. By using prior year data for NHCEs, at the beginning of each plan year the employer will know the amount deferred or contributed by NHCEs during the prior year and be able to calculate the maximum ADP/ACP for HCEs for the current plan year—making the testing process more predictable.

While the prior year testing option has its advantages, it may not be the best choice for every employer. For example, the current year testing method might be the better choice if the ADP or ACP for NHCEs is expected to be higher in 2017 than in 2016.

Because each scenario is different, and there is no rule that works for every group, it makes sense to examine the results under both scenarios, and make decisions based on what is most beneficial to your organization. It is important to note that, if you elect to use current year data for plan testing, you must wait for 5 years before switching to the prior year data testing method.

Assessing Results

If after testing the ADP/ACP test fails, there is a sequence of returning applicable excess amounts to each HCE. Applicable corrections are made by starting with the HCE deferring at the highest percent. The HCE who deferred the highest percent is reduced down to the HCE who deferred the next highest and so forth until the plan passes the test.

Next, we take the adjusted deferral percent and multiply it by each of the reduced HCE's current year compensation and subtract the calculated amount from the original amount deferred to get the total amount that needs to be refunded from the plan.

We then determine the distribution amount for each HCE. We start with the HCE who contributed the most and bring him down to the next highest HCE to see if that satisfies the amount that needs to be refunded and so forth until the amount to be refunded out of the plan is allocated among the HCEs.

Employee	Age	Compensation	Elective Contribution	Contribution Percentage	ADP Reclassified as Catch-up	Refund
HCE1	51	$245,000	$16,500	6.73%	$5,500	$375
HCE2	45	180,000	14,400	8.00%	0	3,775
NHCE1	55	85,000	4,250	5.00%	0	0
NHCE2	32	45,000	0	0%	0	0
NHCE3	25	20,000	700	3.50%	0	0
NHCE4	28	20,000	700	3.50%	0	0

Actual Deferral Percentage for HCE (HCE): (6.73% + 8.00%)/ 2 = 7.37%
Actual Deferral Percentage for NHCEs (NHCE): (5% + 0% + 3.5% + 3.5%) / 4 = 3%. In this example, the ADP of the HCEs cannot be greater than 2% plus the ADP of the NHCEs to pass the test. (3% + 2% = 5%) Because the test failed, the HCEs will receive a refund of their excess deferrals.

Refunds are calculated using a two-step process. First we must determine the amount of the contributions which must be refunded from the plan. The HCE with the highest percent is reduced down to HCE with the next highest deferral percent and so forth until we reach the adjusted deferral percent of 5%, as determined above.

Once we have determined the percentage that each HCE must be reduced we take the adjusted deferral percent and multiply it by each of the reduced HCEs current year compensation and subtract the calculated amount from the original amount deferred to get the total amount that needs to be refunded from the plan.

Employee	Compensation	Elective Contribution Percent	Adjusted Contribution Percent	Amount to be Refunded from the Plan
HCE1	$245,000	6.73%	5.00%	$4,250
HCE 2	$180,000	8.00%	5.00%	$5,400

In this example, a total of $9,650 of deferrals must be refunded out of the plan. We start with the HCE who contributed the most and bring him down to the next highest HCE to see if that satisfies the amount that needs to be refunded and so forth until the $9,650 has been distributed. The employer first returns $2,100 to HCE1, since this is the employee with the highest dollar deferral, to bring the elective contribution of HCE1 down to $14,400, the amount of elective contribution deferred by HCE2. HCE1 and HCE2 would then each receive refunds in the amount of $3,775 (a total of $5,875 for HCE1). Top-paid employees are likely to be more affected whenever a distribution of excess deferrals or contributions is necessary. Since HCE1 is over age 50 and he has not contributed any catch-up for the plan year a portion of his refund can be reclassified as catch-up contributions.

Avoiding Testing Problems

Pentegra's preliminary testing services can provide you with advance information on whether your plan may have any problems passing the test at the end of the plan year. If potential for problems exists, you can take the actions necessary to correct them.

You can take advance planning steps to minimize both the uncertainty and the consequences of the testing process. Among the longer-term design approaches you might adopt:

- Make plan participation more attractive to lower-paid employees through plan redesign, adding more investment options, improving vesting schedules, adding a plan loan feature, or making withdrawal provisions more liberal. Obviously, the cost of these changes must be considered.
- Increase the plan's matching formula. In changing the matching formula, consider that employees aim for a level at which their salary will be matched and may not contribute if no match is available. The match, therefore, should be enough to induce NHCEs to select higher payroll deduction rates.
- Allow immediate participation upon date of hire. Participation may be easier to encourage when employees have just been hired. In addition, new employees will not "miss" the amounts they elect to defer if they have not previously received full pay.
- Improve the level and frequency of employee communications to boost the participation of NHCEs.
- Adopt a nonqualified plan for some or all HCEs. The nonqualified plan might be structured to allow employees to defer salary and receive a matching contribution in the same manner as they would under the 401(k) plan.
- Alternatively, an employer may provide a safe harbor match in order to avoid ADP testing. The safe harbor match is an employer match on the employee's 401(k) contributions equal to 100% of the first 3% of compensation plus a 50% match for the next 2% of compensation (i.e., the contributions in excess of 3% of compensation, but not in excess of 5% of compensation). Other matching formulas that provide as beneficial a match may constitute a safe harbor match.
- Employer contributions that are utilized to satisfy the safe harbor must be immediately vested, and will only be able to be distributed under the same circumstances that apply to 401(k) contributions (generally termination of service, attainment of age 59½, death or disability).
- Add an Eligible Automatic Contribution Arrangement (EACA)
- Add a Qualified Automatic Contribution Arrangement (QACA)

Section 415 Limitation Testing

Defining 415 Limitation Testing

Section 415 of the Internal Revenue Code sets limits on "annual additions" made to a participant's account. The IRS sets limits on the amount that can be allocated to an employee under a defined contribution plan as well as the level of benefit an employee may receive under a defined benefit plan.

The 415 limitations or annual addition for defined contribution plans is generally defined as the sum of the following:

- Employer contributions
- Employee contributions
- Forfeitures

The annual addition made to a participant's account each year may not exceed the lesser of $55,000 in 2018 (indexed) or 100% of the participant's compensation.

The annual benefit that a participant may receive under a defined benefit plan is limited to the lesser of $220,000 in 2018 (indexed) or 100% of average compensation for the highest three years.

Assessing Results

You can correct a 415 limitation violation under a defined contribution plan by refunding employee deferrals or contributions. 415 limits should be monitored throughout the plan year in order to avoid problems.

415 limits should be reviewed prior to allocating year-end employer contributions, so as to make any necessary adjustments. If you must scale back on a deferral or after-tax contribution, you must also make sure to scale back on the corresponding match.

Pentegra performs required 415 limitation testing annually and refunds and/or forfeits any excess contributions and earnings in order to ensure plan compliance. If more than one plan (i.e. ESOP, 401(k)) is administered by Pentegra, we will prepare a combined test inclusive of all contribution types.

Top-Heavy Testing

Defining Top-Heavy Testing

A "Top-Heavy" defined contribution plan is defined as a plan in which the total value of the accounts of all key employees (certain highly compensated officers and owners) exceed 60% of the total account values for all employees.

A top-heavy defined benefit plan is defined as a plan in which the present value of the accrued benefit of all key employees exceeds 60% of the present value of the accrued benefits for all employees.

Defining Key Employees

A key employee generally is an employee who, at any time during the plan year, is:

- 5% owner.
- An officer whose annual compensation is in excess of $175,000 (indexed).
- 1% owner earning more than $150,000

Testing Requirements

If a plan is deemed "top-heavy," it must provide a more liberal vesting schedule as well as a minimum level of employer contributions described below.

Under a defined contribution plan that is deemed "top-heavy," the minimum required contribution for non-key employees is generally the lesser of:

- 3% of compensation, or
- the highest contribution percentage rate for any key employee

Under a defined benefit plan that is deemed top-heavy, the annual retirement benefit of a non-key employee must not be less than the employee's average compensation over a 5-year period multiplied by the lesser of:

- 2% times the number of years of service
- 20%

If a non-key employee participates in both, a top-heavy defined benefit plan and a top-heavy defined contribution plan, top-heavy minimums (benefits or contributions) only have to be provided under one of the plans.

A determination is made annually with regard to a plan's top-heavy status. Pentegra works with employers on an ongoing basis to ensure continued plan compliance.

Minimum Coverage & Participation Testing

Defining Minimum Coverage Testing

The minimum coverage test is designed to ensure that a retirement plan covers a sufficient number of employees.

Specifically, an appropriate number of NHCEs must be covered under the plan to make sure that plan eligibility is not disproportionately concentrated among HCE.

Testing Requirements

A retirement plan must satisfy one of the following coverage tests.

Ratio Percentage Test

- The plan benefits— (i) A percentage of employees who are not HCE which is at least 70 percent of (ii) The percentage of HCE benefiting under the plan.

Average Benefits Test

In order to pass the average benefit test, the plan must pass the nondiscriminatory classification test and the average benefits percentage test. The average benefits percentage test requires that the average benefit percentage for employees who are not HCE is at least 70 percent of the average benefit percentage for HCE.

Unless testing is performed separately by line of business, for testing purposes all employees in the controlled group are considered, except those who can be excluded from testing for various reasons.

Defining Minimum Participation Requirement

In addition to the minimum coverage requirements, defined benefit plans must also meet a minimum participation requirement in order to be IRS-qualified. To satisfy the requirement, a plan must pass the test on each day of the plan year. In some cases, the IRS allows for alternative tests.

Testing Requirements

Each defined benefit pension plan the employer maintains must benefit at least the lesser of 50 employees or 40% of all employees. The minimum participation requirement, which must be met each day of the plan year, was designed to restrict different organizations within a controlled group from adopting different plans.

Defining Excludable Employees

For purposes of applying the tests, all employees other than excludable employees must be taken into account.

If an employee falls under one of the following categories, they may be excluded for testing purposes:

- An employee who does not meet the plan's age or service requirement
- An employee who is a nonresident alien who received no earned income from sources within the U.S.
- An employee who is a union member whose retirement benefits have been the subject of good-faith bargaining between the employer and the union

Assessing Results

If a plan fails to satisfy the minimum participation and coverage requirements, the plan may be retroactively amended to satisfy the requirements by expanding coverage, improving benefits or contributions or modifying eligibility requirements under the plan. Pentegra works with clients in examining these options and selecting an appropriate course of action.

The complex regulatory environment surrounding retirement plans has created unique challenges for plan sponsors. Pentegra can provide the consulting support needed to address plan design issues. For more information, contact your Plan Consultant at 1-800-872-3473, or www.pentegra.com.