

401(k) Plan Nondiscrimination Testing: Guidance for Employee Benefits Counsel

Meeting IRS Requirements, Avoiding Corrective Distributions,
Evaluating Safe Harbor Plans, Navigating Multiemployer Plan Complexities

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Strafford Webinar

401(k) Non-Discrimination Testing

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Non-Discrimination Testing

Introduction

- Topics Covered
 - ADP and ACP Mechanics
 - Other Nondiscrimination Tests
 - 410(b) Coverage
 - Benefits, Rights and Features
 - Controlled Groups
 - Plan Aggregation and Disaggregation
 - Correction of Testing Failures
 - Safe Harbor Rules

Non-Discrimination Testing

Key Concepts

- Cash or Deferred Arrangement
 - Choice of cash or pre-tax plan contribution
- Highly Compensated Employee (HCE)
 - \$120,000 or more annual compensation
 - 5% Owner
 - Ability to afford higher plan contributions
- Discrimination Testing: regulates relationship between:
 - NCE contributions
 - NHCE contributions

Non-Discrimination Testing

Actual Deferral Percentage Test (ADP)

- Two alternate percentage tests set limit on HCE deferrals
 - 1.25% of NHCE ADP or
 - 2 percentage points more than NHCE ADP or 2 times NHCE ADP
- ADP: the average of individual deferral ratios by group
 - One average for HCEs
 - Another average for NHCEs
- Current year HCE ADP compared to prior year NHCE ADP

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Actual Percentage Contribution Test (ACP)

- Amounts covered by ACP test:
 - Employer matching contributions
 - Employee after-tax contributions
- Basis of test is average of individual contribution ratios
- Same 1.25 and 2.0 percentages as ADP test
- Prior year testing unless current year testing elected

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Compensation

- Denominator of deferral percentages and contribution percentages is compensation for plan year
 - W-2 wages
 - Wages subject to withholding
 - Modification by disregarding fringe benefits allowed
- Broader compensation definition reduces deferral and contribution ratios, maximizing testing for HCEs
- Narrower compensation definition easier to track

Non-Discrimination Testing

Nondiscrimination Tests - Coverage

- Code §410(b) minimum coverage test –
3 alternatives
 - Percentage test
 - Ratio test
 - Average benefits test
- Employee treated as “benefitting” under plan if eligible to elect 401(k) deferrals

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Benefits, Rights & Features Testing

- HCEs and NHCEs must have equal access to each tier of deferrals or matching contributions
- Potential violations of benefits, rights & features requirement:
 - Limiting deferrals to a percentage of compensation in excess of the Social Security wage base
 - Matching contributions available only with respect to elective deferrals above a specified level of compensation, such as 5%

Non-Discrimination Testing

Controlled Groups

- Members of controlled group treated as a single employer for purposes of nondiscrimination testing
- Controlled group definition
 - 80% Ownership Test
 - Brother-Sister Test

Non-Discrimination Testing

Mandatory Plan Disaggregation

- Treated as covered by separate plans for nondiscrimination testing purposes:
 - Employees covered by CBA and
 - Non-unionized employees
- Members of separate CBA bargaining units also treated as participating in separate plans
- Multiemployer plan divided into separate plans for CBAs with different benefit formulas
- MEP consists of separate plans maintained by each adopting employer

Non-Discrimination Testing

More Plan Disaggregation Scenarios

- Qualified separate lines of business result in separate plans for each line
- Separate plan deemed for employees not meeting minimum age (21) or service (1 year) requirements for eligibility
- ESOP and non-ESOP portions of DC plans are treated as separate plans

Non-Discrimination Testing

Designed Plan Divisions and Plan Aggregation

- Bases for creating formally separate plans to improve testing:
 - Salaried/hourly
 - Employee classifications
 - Business units
 - Geographical locations
- Each legally separate plan must pass 410(b) coverage test on a stand-alone basis to be respected
- Multiple CODAs under same plan cannot be subject to different testing methodologies, such as ADP or safe harbor testing

Non-Discrimination Testing

Curing ADP Testing Failures

- Make sufficient QNECs or QMACs to pass ADP / ACP tests
- Return excess contributions to HCEs
 - Deadline is 12 months after plan year being tested
 - 10% excise tax on employer if excess not distributed within 2½ months of year-end
 - Returned excess contributions taxed in year distributed

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QNECs and QMACs

- QNEC: discretionary nonelective employer contribution
- QMAC: discretionary employer matching contribution
- QNECs and QMACs credited to NHCEs increase their deferral and/or contribution ratios and facilitate passing ADP/ACP tests
- Limit on QNECs/QMACs taken into account for testing purposes
 - Limit intended to prevent large contributions targeted to employees with minimal compensation

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Safe Harbor Plans

- Safe harbor plan eliminates cost & uncertainty of nondiscrimination testing but can be expensive
- Safe harbor contributions
 - 3% employer contribution
 - Matching contribution equal to 100% of 1st 3% of compensation deferred; 50% of next 2% of compensation deferred
 - Must be fully vested to pass ADP test
- Adoption required before beginning of tested year
- Must be in effect for full plan year
- Advance employee notice required

Non-Discrimination Testing

Safe Harbor Plans – 12 Month Rule

- Safe harbor using 3% employer contribution can be adopted after beginning of year tested
 - Plan must be amended no later than 30 days before year end
 - Participants notified of possible safe harbor amendment before year begins
- New safe harbor plan can be adopted during first 9 months of plan year
- Safe harbor match can be suspended mid year subject to 30-day advance notice to participants

Non-Discrimination Testing

QACAs

- QACA safe harbor exempt from ADP testing
- Deemed 3% deferral in 1st year
- Automatic 1% increases in deemed deferrals for later years up to 6%
- Requires vested 3% employer contribution
- Alternative matching contributions equal to 100% of 1st 1% and 50% of next 5% of deferred compensation

Non-Discrimination Testing Conclusion

- Purpose of nondiscrimination testing: ensure meaningful retirement savings for rank & file
- Testing consumes significant employer resources
- Retirement system expansion currently focused on 401(k) plan adoption by small employers and start-ups
- Potential development of new safe harbors to encourage plan adoption

Starting Plans

	Info Systems	Auto Repair
HCEs	800	200
ADP for HCEs	5%	10%
NHCEs	2,500	7,500
ADP for NHCEs	1%	5%

Combine or “Aggregate” Plans

	Info Systems (“Jelly”)	Auto Repair (“PB”)	Aggregated (“Sandwich”)
HCEs	800	200	1,000
ADP for HCEs	5%	10%	6%
NHCEs	2,500	7,500	10,000
ADP for NHCEs	1%	5%	4%
	Fail	Fail	Pass

Aggregating Plans

- HCEs in both plans – count twice in separate plans (using total contribution), once in aggregated plan
- NHCEs in both plans – count in both plans but only using the contribution in that plan, once in aggregated plan.

Aggregated Plan – Ease Up on HCEs (Increase HCE Limit)

	Aggregated ("Sandwich")
HCEs	1,000
ADP for HCEs	7%
NHCEs	10,000
ADP for NHCEs	4%

Cut Sandwich into Two Triangles

	Combined ("Sandwich")	Salaried	Hourly
HCEs	1,000	980	20
ADP for HCEs	7%	6.98%	8%
NHCEs	10,000	6,000	4,000
ADP for NHCEs	4%	5.33%	2%

Ways to Cut

- Hourly / Salaried
- Exempt / Non-exempt
- Business Unit
- Location
- Line of Business
- Attorney / Staff
- Partners / Associates
- **Each plan must somehow pass coverage test**

Additional Ingredients

- Targeted QNEC (or “bottom up QNEC”)
 - For ADP: Limited to 5% or 2 x median deferral percentage
 - For Average benefits test – not limited
 - So, for ABT, give 100% of pay QNEC to those employees who earned under \$1,000 (typically terminated in January). \$1,000 for one employee is equivalent to \$50,000 spread among 20 employees who each make \$50,000 per year.
 - Note for ABT, may weight by age (“benefits basis”) further increasing the effect.

Borrowing

	Pass 1	Pass 2	Pass 3
HCEs – ADP	7.0%	7.0%	5.0%
NHCE – ADP (w/ QNEC)	4.1%	5.0%	3.0%
HCE – ACP (QMAC)	2.0%	2.0%	4.0%
NHCE – ACP (QMAC)	0.9%	0.0%	2.0%
Result	Fail!	Pass	Pass

Additional Ingredients

- Qualified Separate Lines of Business (QSLOB) IRC § 414(r) and 410(b)(5)
- Test excludable employees separately § 410(b)(4)
- Safe harbor contributions § 401(k)(12)
- QACA § 401(k)(13)
- Roth 401(k)
- Boosting participation

QSLOB

- Lines of business
- Separate management / organizational unit
- Separate financial reports
- Separate workforce
- 50 Employees
- Notice requirement – Form 5310-A
- Administrative scrutiny !

QSLOB Administrative Scrutiny Alternatives

- Request ruling from IRS
- Different industries – IRS industry categories
- Same average benefits
- Min / Max benefits
- M&A test – for limited time period (two years longer than 410(b) transition period)
- Industry segments – separate financial statement schedule required
- 50 / 200 test

QSLOB 50 / 200 Test

- $(S\text{-HCE} / (S\text{-HCE} + S\text{-NHCE})) / (HCE / (HCE + NHCE))$
- $50\% \leq \text{Ratio} \leq 200\%$
- Or SLOB has at least 10% of HCEs