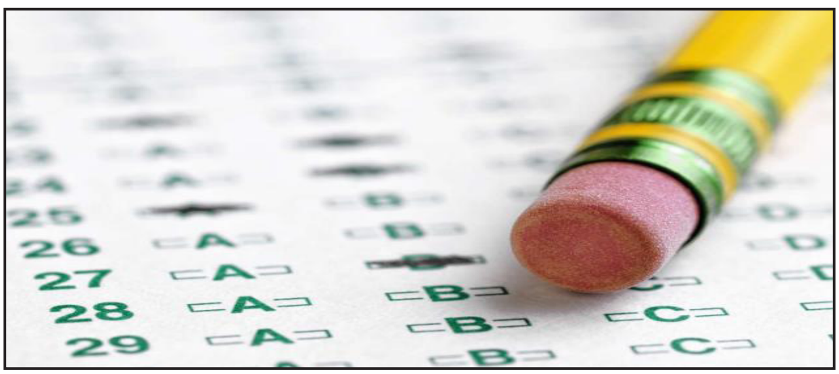
A Plan Sponsor's Guide to 401(k) Compliance Testing

By Ary Rosenbaum, Esq.

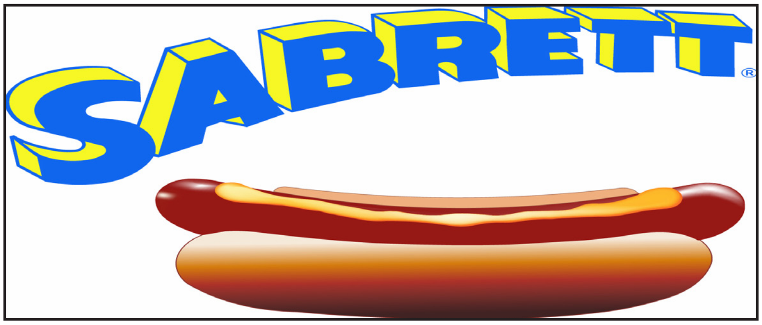
My great uncle was in the meat provisions business for over 40 years. When Uncle Jack told us which hot dogs we should eat, we trusted his opinion because he knew how hot dogs were made (the company he worked for made Sabrett). While 401(k) plan administration is a lot cleaner that the hot dog business, plan sponsors are usually unaware of the intricate work performed by third party administrators (TPAs). That's a concern because then most plan sponsors don't value the role of a good TPA. A good part of a TPA's work is the performance of compliance testing to make sure that the plan passes the required discrimination testing which is a requirement of the Internal Revenue Code that a qualified retirement plan must do. So this article describes the fundamentals of compliance testing for 401(k) plans, so plan sponsors can better understand the role of a good TPA in dealing with the administration of a 401(k) plan.



It's all about Discrimination: The Internal Revenue Code mandates these annual compliance tests because the Internal Revenue Code does not want qualified plans to discriminate in favor of highly compensated employees. A highly compensated employee is an individual who: owned more than 5% of the employer at any time during the year or the previous year, regardless of how much compensation that person earned, or for the preceding year, received compensation from the business of more than $115,000 (if the preceding year is 2012), and, if the employer so chooses, was in the top 20% of employees when ranked by compensation. Another interesting point is that you can always discriminate against highly compensated employees. So a law firm could discriminate against their high paid associates or partners in limiting their participation or contribution. I mentioned this once at a continuing education course at a law firm and got some dirty looks.

Garbage in, garbage out: Any compliance testing is dependent on accurate information and most of that information is furnished by the plan sponsor in the annual census. So if the TPA is using bad or missing data, the compliance test will be incorrect. A plan sponsor needs to make sure all the data furnished on the census is correct including dates of birth, dates of hire and termination, and compensation. In addition, the plan sponsor should identify any relatives of highly compensated employees and any companies where there is common ownership with the plan sponsor to make sure that there are no additional companies that need to get lumped in on the compliance test. Plan sponsors that are unaware how to fill out a census, should consult with their TPA to make sure that they are providing the correct information they need to complete the census.

Coverage: Any 401(k) plan must conduct a coverage test to make sure that the plan does not exclude participants through discrimination against the non-highly compensated employees. Section 410(b) sets out the rules on who the plan must cover. In order to satisfy this Code section, a plan must meet one of the following tests: The plan benefits at least 70 percent of employees who are not highly compensated employees (percentage test) or the plan benefits: a percentage of non-highly compensated employees which is at least 70 percent of (ii) the percentage of highly compensated employees benefiting under the plan (ratio test). The alternative test is called the average benefit percentage test where the plan must benefit a classification of employees that does not discriminate in favor of highly compensated employees (nondiscriminatory classification test) and the average benefit percentage of the non-highly compensated employees must be at least 70 percent of the average benefit percentage of the highly compensated employees. For purposes of Code section 410(b), employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are nonresident aliens receiving no U.S. source earned income from the employer can be excluded from consideration and won't count towards the test. The same treatment is also for employees who don't meet the plan's eligibility requirements. The interesting part of the coverage test is that you can make classifications that can exclude certain employees who become excluded if you pass the coverage test, but you run the risk that the Internal Revenue Service will say that the classification is unreasonable. Excluding part-time employees is considered an unreasonable classification, so is excluding certain employees by name. Changes in employee demographics may affect the way that the plan satisfies the coverage tests annually such as employee turnover or a merger or purchase of assets from another business that comes with new employees. If a plan fails the coverage test, the plan documents usually has fail-safe provisions that add back certain excluded participants into the plan to pass. A 401(k) plan will have separate coverage tests for the salary deferral, matching, contribution, and profit sharing components of the plan.



ADP and ACP Test: The Actual Deferral Percentage test (ADP) for salary deferrals and the Actual Contribution Percentage (ACP) test for matching contribution must be passed The ADP test compares the average salary deferral - as a percentage of pre-tax compensation - of highly compensated employees (HCE) to that of non-highly compensated employees (NHCE). To pass the test, the ADP of the HCE may not exceed the ADP of the NHCE by a factor of 1.25 or 2 percentage points. The ACP test uses a similar method as the ADP test, except that it looks at matching contributions. If a plan fails one or more of these tests, the plan sponsor may have to make fully vested qualified contribution to non-highly compensated employees or make refunds of salary deferrals or forfeit matching contributions. For plan consistently having an issue with ADP and/or ACP test, using a Safe Harbor 401(K) plan design going forward will make the plan sponsor avoid the ADP/ACP test entirely.

Top Heavy: Unlike some of the other tests, a Top-Heavy test isn't really pass or fail, it's more like the plan is Top-Heavy or it's not. Each plan year, it must be determined whether the plan is "top-heavy." A plan is top-heavy if, as of the determination date, the total account value of key employees exceeds 60% of the total account value of all employees in the plan. A key employee is not someone who is just key to your business. It's an officer of the employer with compensation greater than $165,000 for 2013 (and will be increased annually for inflation or a more than 5% owner (and family members) of the employer, or a more than 1% owner (and family members) who earned more than $150,000 (not indexed) during the determination year. For existing plans, the determination date is the last day of the plan year immediately preceding the plan year being tested or for new plans, the determination date is the last day of the current plan year. When a Plan is top-heavy or deemed top-heavy, contributions must be made for all non-key employees equal to the lesser of 3% of compensation or a percentage equal to the highest contribution rate of any key employee. Safe harbor 401(k) plans have been deemed to satisfy the top-heavy requirements, so a test is not necessary.

The General Test: If a 401(k) plan uses a comp-to-comp allocation (where all employees get the same percentage contribution based on compensation) or an integration allocation (based on the Social Security Wage Basis), that plan will satisfy the discrimination requirement for allocations. For plans with a cross tested/new comparability allocation, the plan must pass the general test. The TPA will determine allocation rates for all participants. An allocation rate is determined by taking the sum of all employer contributions and forfeitures allocated to the participant's account that year and dividing it by the participant's annual compensation. The TPA will then compare the allocation rates for all participants by rate groups. A rate group exists for each HCE. A rate group for a particular HCE includes all participants, both HCEs and NHCEs, who have an allocation rate equal to or greater than the HCE. Each rate group is treated as if it was a separate plan and as such each rate group must then satisfy the coverage rules we discussed before. It's very complex, but keep in mind that a plan with an out of the box allocation like cross-tested needs to pass it.

Benefits, Rights, and Features: If a plan offers a loan program to the owners of a company or offer an investments to employees who have more than $25,000 in their account balance, then that feature or benefit must be tested to ensure it's not discriminatory. Optional forms of benefits, ancillary benefits, and other rights and features provided under the plan must be nondiscriminatory. Each optional form of benefit must be currently available and effectively available to a nondiscriminatory classification of employees. Current availability focuses on the availability of the option to employees but assumes that certain conditions such as age or service under the plan's terms are currently satisfied. Effective availability examines whether actual availability of the option, taking into account the ability of employees to satisfy age and service requirements, substantially favors highly compensated employees.

Why Plan Sponsors Should Care: The compliance tests are very complex and intricate. Finding a TPA that can't conduct these tests correctly is a recipe for disaster. I have been paid too much money to correct compliance test errors years later that were only caught because the plan sponsor changed TPAs or because an Internal Revenue Service (IRS) agent was reviewing the plan on audit. Compliance tests need to be done correctly, to maintain the plan's tax qualification, so that's why it's important to pick a competent TPA rather than concentrating on finding the cheapest provider or some perceived integration by using your payroll provider as TPA.

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