RETIREMENT PLAN PERSPECTIVES

Insights for Your Plan and Employees

Q4 2018

'Tis the (Nondiscrimination Testing) Season!

During the festive holiday season, 401(k) nondiscrimination testing probably isn't at the top of many retirement plan sponsors' minds. But nondiscrimination testing is a critical function of operating a healthy retirement plan—not to mention an important mandate of ERISA.

Let's take a look at what nondiscrimination testing is, some need-to-know terms and concepts, and how this important task affects *your* company's retirement plan.

What is nondiscrimination testing?

ERISA requires a retirement plan to undergo annual calculations to ensure that the plan doesn't disproportionately benefit a specific group of employees (highly compensated employees [HCEs]) and that plan participants haven't exceeded IRS contribution limits. These calculations are referred to as nondiscrimination testing.

Is there a deadline to complete nondiscrimination testing?

Generally, the deadline is two and a half months following the plan's year-end (March 15 for calendar year plans).

Who is responsible for performing nondiscrimination testing?

Your service provider (e.g., a third-party administrator or recordkeeper) will likely perform nondiscrimination testing as part of its contracted services.

Who is an HCE (and who is not)?

For 2018 tests, an HCE is classified as any employee who is either:

- A greater than 5 percent owner of the business at any time during the year for which the test is being conducted (**Please note:** Family members of a greater than 5 percent owner are attributed to own the same interest for purposes of nondiscrimination testing.), or
- Someone who earned more than $120,000 in compensation in the previous year (For example, when performing a 2018 test, HCE compensation would be determined by looking back to 2017 compensation to determine HCE status.)

Conversely, a non-HCE (NHCE) is any eligible employee who does not fit into one of the two categories above. With that background in mind, let's examine the different varieties of nondiscrimination tests.

'Tis the (Nondiscrimination Testing) Season! *continued*

The average deferral percentage (ADP) test

Although HCEs may freely (if they meet eligibility requirements) contribute to their retirement plan up to IRS-imposed limits (or plan-imposed limits, if applicable), the ADP test is applied to ensure that the HCEs do not contribute *proportionately more* than the NHCEs. The ADP test measures the average salary deferral (pretax and Roth but *excluding* catch-up contributions) percentage of the HCE group against the average salary deferral of the NHCE group. To pass, the average deferral percentage of the HCEs must not exceed the NHCE average deferral percentage by 1.25 percentage points or 2 percentage points, as illustrated in the table below:

Maximum Annual NHCE Contribution Rate	Maximum Annual HCE Contribution Rate
Less than 2%	NHCE% x 2
2%–8%	NHCE% + 2
More than 8%	NHCE% x 1.25

The average contribution percentage (ACP) test

The ACP test compares the employer matching contributions of HCEs with those of NHCEs. Also, if an employee (either an HCE or NHCE) contributes after-tax dollars, they would be factored into the ACP test. Once average rates are determined, the test is performed in the same manner as the ADP test.

What if the ADP or ACP test fails? A failing test is corrected with one of two methods. The first (and most common) method is to refund excess contributions to HCEs to the degree that it would lower the HCE average contribution percentage to a passing rate. The amounts are determined by a specific calculation and may or may not require each HCE to receive a refund. If a test fails and corrective action is required, timing is important. Corrective refund transactions must be completed by two and half months (March 15 for calendar year plans) after the plan year. If they are not, then a 10-percent excise tax (payable by the employer) may apply to the refunded amounts. Any pretax amounts refunded to an HCE would be taxable in the year in which they were distributed back to the HCE.

The second method is to make additional contributions to employee accounts in the NHCE group to the degree that it would raise the NHCE average contribution percentage rate to a passing level.

The top-heavy test

While both the ADP and ACP tests measure contribution averages, the top-heavy test measures overall *balances* of two distinct groups: key employees and nonkey employees. A key employee is:

- An officer of the company with gross compensation exceeding $175,000 (in 2018), or
- Employees of the company in the year for which the plan is being tested who:
  - Own greater than 5 percent of the company (**Please note:** Family members of a greater than 5 percent owner are attributed to own the same interest for purposes of nondiscrimination testing.), or
  - Own greater than 1 percent of the company (family attribution also applies) in the year for which the plan is being tested and had $150,000 or more in compensation

'Tis the (Nondiscrimination Testing) Season! *continued*

Once the key employee population is determined, their balances are aggregated and compared with the aggregate balances of nonkey employees. The balances of key employees cannot exceed 60 percent of the plan balance at the end of the plan year.

What if the top-heavy test fails? Generally, to correct a top-heavy test failure, the employer must make a minimum nonelective contribution to nonkey employees.

The safe harbor plan: A cure for testing headaches?

So, if your plan consistently fails nondiscrimination testing, is there anything you can do? Absolutely! A safe harbor plan eliminates the need for nondiscrimination testing. To qualify for safe harbor status, the employer must make a matching contribution, such as the following:

- **Basic safe harbor match:** The employer matches 100 percent of all employee contributions up to 3 percent of compensation, plus an additional match of 50 percent of their next 2 percent of compensation (for an effective 4-percent contribution).
- **Enhanced match:** A matching contribution must be as generous as the basic match at any level of employee deferral. A common formula is the employer matches at least 100 percent of all employee contributions, up to 4 percent of their compensation (not to exceed 6 percent of compensation).
- **Safe harbor nonelective contribution:** The employer contributes 3 percent of each employee's compensation (regardless of whether the employees defer).

Sometimes, however, a drastic shift in plan design is not what's needed to narrow the gap between HCE and NHCE contribution rates. Consider tweaking your plan by adding auto-enrollment or auto-escalation features—both will help most employees defer a higher percentage of their salary, raising the collective average of their contribution rate. Or, conduct a campaign to raise awareness of saving for retirement through a 401(k) plan. You'll reap the benefits of improved worker morale, and your employees will take a positive step toward their future.

Additional tests to consider

The coverage test. To comply with IRC 410(b), this nondiscrimination test ensures that a sufficient number of NHCEs (70 percent at a minimum) are covered by the 401(k) plan, relative to the HCEs.

IRS statutory limits. The IRS imposes limitations on contributions to a retirement plan in one year. The **annual additions test** aggregates all an employee's contributions (both elective deferrals and employer contributions) to ensure that they don't exceed the 2018 combined defined contribution limit of $55,000 under IRC 415. The **elective deferrals test** verifies that an employee does not exceed the statutory elective deferral limit of $18,500 (for 2018) under IRC 402(g).

Administering a retirement plan takes a significant amount of time, care, and oversight. When it comes to nondiscrimination testing, some exceptions and nuances apply based on specialized scenarios beyond what is described above. So, where needed, tap into the expertise of service providers, such as your third-party administrator, recordkeeper, or plan advisor, for guidance.

New Year's Checklist for Retirement Plan Stewards

A new year is the perfect time for retirement plan sponsors and fiduciaries to reflect on all aspects of their retirement plans. Below are some fundamental areas to focus on to promote good fiduciary, plan, and participant health in 2019 and beyond.

- ☐ **Boost participant savings rates.** Are your employees saving enough? Analyze current participant balances and participation rates and compare them with historical participant benchmarks.
- ☐ **Take a fresh look at your plan's design.** When was the last time you put your plan's design under the microscope? If it's been more than a year or two, changes may be in order. Does the plan offer auto-features and an incentivizing matching contribution for your employees? Has the design of the plan kept up with the needs of business owners or key stakeholders?
- ☐ **Tighten up the process for investments.** Creating an investment policy statement (IPS) is the starting point for investment committees and plan fiduciaries. The selection, analysis, and, if needed, replacement of the plan's investments should follow the process in the IPS. Does the investment menu cover desired sectors and categories, as well as offer target-date fund options?
- ☐ **Audit plan fees and expenses.** Ongoing expense monitoring and benchmarking are vital. Plan sponsors have a fiduciary responsibility to know whether fees charged to the plan by service providers are reasonable for the services they are rendering, and most industry experts recommend that formal benchmarking take place at least every two years.
- ☐ **Document.** Maintaining a well-organized 401(k) file (either hard copy or digital) of important plan documents, vendor correspondence, contracts, forms, and agreements not only helps you meet ERISA record retention requirements, but it also helps prepare you for an audit.

We Can Help

Contact us to learn more about maintaining the health of your company's retirement plan through annual nondiscrimination testing, as well as to discuss any other aspect of your plan. We're ready and willing to help.

Investments are subject to risk, including the loss of principal. Some investments are not suitable for all investors, and there is no guarantee that any investing goal will be met. Past performance is no guarantee of future results. Talk to your financial advisor before making any investing decisions.

Commonwealth Financial Network® does not provide legal or tax advice. Please contact your legal or tax advisor for advice on your specific situation.

Securities and advisory services offered through Commonwealth Financial Network®, Member FINRA/SIPC, a Registered Investment Adviser.

© 2018 Commonwealth Financial Network®

Third Party Administrator (TPA) services offered by Boulay, Donnelly & Supovitz Consulting Group are separate and unrelated to Commonwealth.