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What an Employer Can Do to Avoid 401k Nondiscrimination Testing Failures

By Anthony L. Scialabba, Esq.

The Internal Revenue Code of 1986, as amended ("Code"), provides that to have a "tax-qualified" 401k plan, elective deferral contributions made by "highly compensated" employees (generally employees who are five percent or more owners or employees who earned over $120,000 (indexed for cost-of-living increases) in the immediate prior plan year ("HCEs")) to a 401k plan and matching contributions received by such employees must not discriminate when compared to the amount of the elective deferral contributions made by rank-and-file employees (also known as "non-highly compensated" employees ("NHCEs")) and matching contributions received by such employees. Thus, plan sponsors must test their 401(k) plans each year to ensure that the contributions made by and for NHCEs are proportional to contributions made by and for HCEs. If a plan does not pass the nondiscrimination testing, this can cause plan sponsors and/or HCEs to have adverse consequences. This article addresses what a plan sponsor can do to avoid the failures in the future.

I. Introduction

The nondiscrimination tests for 401(k) plans are called the "Actual Deferral Percentage" test ("ADP Test") and the "Actual Contribution Percentage" test ("ACP Test") (together "Nondiscrimination Tests"). In general, the tests are performed as follows.

The ADP Test concerns discrimination involving elective deferral contributions (both "pre-tax" and "Roth" deferrals, but not "catch-up"

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contributions). The test requires that a participant's elective deferrals are divided by the participant's compensation. This produces a participant's "Actual Deferral Ratio" ("ADR"). The average ADR for all eligible NHCEs (regardless as to whether they defer) is the "Actual Deferral Percentage" ("ADP") for the NHCE group. The same calculations are performed for the HCEs to determine their ADP.

The ADP test is met if the ADP for the eligible HCEs does not exceed the greater of:

- 125% of the ADP for the group of NHCEs, or
- the lesser of:
  - 200% of the ADP for the group of NHCEs, or
  - the ADP for the NHCEs plus 2%.

The ACP Test is generally performed in the same way as the ACP Test. However, each participant's matching and after-tax contributions is divided by the participant's compensation.

The ACP test is met if the ACP for the eligible HCEs does not exceed the greater of:

- 125% of the ACP for the group of NHCEs, or
- the lesser of:
  - 200% of the ACP for the group of NHCEs, or
  - the ACP for the NHCEs plus 2%.

If a plan fails the ACP or ADP (or both), there are two corrective options. The most common method used to correct a failed ADP Test or ACP Test is to make corrective distributions of the excess deferrals or contributions, plus earnings (in some cases, forfeiture of matching contributions may be required), to HCEs. In general, corrective distribution amounts (determined by a certain leveling method) are first offset by the unused catch-up contributions if the plan permits catch-up contributions, a participant is 50 or older and has unused catch-up contributions remaining. The remaining amount of corrective distributions is generally allocated among HCEs based on the dollar amount of their deferrals or contributions.

These distributions must be made within 2½ months of the plan year-end in order to avoid a 10% penalty (this deadline is extended to six months for plans that meet certain automatic contribution arrangement requirements). However, if the corrective distributions are not made by the last day of the following plan year, then a plan is considered to not be operated in a tax-qualified manner. These distributions are taxable in the year in which they are distributed.

A failed nondiscrimination test can also be corrected by having the employer make a "qualified nonelective contribution" ("QNEC") or "qualified matching contribution" ("QMAC"). These additional employer contributions are made to NHCEs to increase their ADP or ACP to the level required for the HCEs to pass either the ADP Test or ACP Test. These contributions must be immediately and fully vested when made, are subject to certain withdrawal restrictions and are required to be deposited by the last day of the following plan year. Thus, the option of curing a failure of the Nondiscrimination Tests by making QNECs or QMACs can be expensive from the perspective of an employer.

II. Modifications that Can Be Made to a 401k Plan

Since correcting failures of the Nondiscrimination Tests can cause morale issues if refunds are made or can be costly if QNECs/QMACs are provided, an employer has an incentive to avoid such failures. The following discusses how this can be done by modifying how a 401k plan is structured and/or operated.

A. Automatic Enrollment

The more salary that NHCEs defer into a retirement plan, the greater the propensity that the Nondiscrimination Tests will be satisfied. As

mentioned above, this is because the tests examine the disparity between the amount of elective deferral contributions that the group of HCEs or NHCEs defers or the amount of matching contributions that the groups receive. The less disparity, the less propensity that there is that the tests will be failed. Usually, NHCEs do not make much elective deferral contributions when compared to HCEs "percentage-wise". Thus, if the percentage of elective deferral contributions for the group of NHCEs can be increased, the disparity at issue should be reduced. One way that the percentage of elective deferral contributions for the group of NHCEs can be increased is through the use of an "Automatic Contribution Arrangement" ("ACA") provision.

In general, a "basic" ACA under a plan is designed to make an employee automatically defer to the plan a certain uniform percentage of his or her compensation. However, the employee may affirmatively elect a different percentage or elect to forgo withholding entirely within a certain time period before the provision is effective.

There are two additional types of ACAs that may be implemented under a plan. One of these is known as an "eligible automatic contribution" arrangement ("EACA"), the other is known as a "qualified automatic contribution" arrangement ("QACA").

An EACA and a QACA have the same basic criteria as an ACA. However, an EACA and a QACA may only be implemented prior to the beginning of a plan year and must take effect on the first day of such year. There are also certain notice and notice-timing requirements that must be satisfied with respect to an ACA, EACA and QACA.

An EACA can have a 90-day opt out provision which allows enrolled participants to retroactively decline participation in the plan and receive a distribution of his or her deferrals, adjusted for earnings (any corresponding match is forfeited). In addition, with regard to an EACA, the employer will have six months, rather than the normal two and one half months, after the end of the plan year to perform the non-discrimination tests that apply to elective deferrals and matching contributions and make the necessary corrective distributions.

In addition to, or as an alternative of, an EACA, a plan sponsor may implement a QACA feature. In general, if an employer establishes a QACA, it will be exempt from the ADP Test or ACP Test if the following are satisfied:

(1) a plan provides a mandatory employer contribution of: a) a matching contribution of at least: 100% on the first 1% plus 50% of the next 5%, or b) an employer nonelective contribution equal to 3% of pay to all eligible participants; and

(2) employer contributions under a QACA are 100% vested after an employee has completed two years of service.

If an employer implements a QACA feature in a plan, the default percentage must commence at three percent of an employee's compensation and gradually increase to six percent. However, it cannot exceed ten percent. In addition, a plan with a QACA feature may not distribute any of the required employer contributions because an employee incurred a financial hardship.

In addition to having an automatic enrollment feature in a plan, the plan may also implement the feature and have the percentage of compensation automatically contributed to the plan increase automatically. This is known as an "automatic escalation" provision. Usually, such a provision would take effect at the beginning of each year, and the plan would automatically raise the percentage of pay that plan participants contribute by one percent or more, until they achieve a set deferral rate (e.g., ten percent of their compensation).

There are certain downsides to the utilization of an auto enrollment provision. One of these downsides is that the provision causes a "forced" contribution. This could cause morale issues.

B. Increase the Matching Contribution and Other Employee-friendly, Plan Design Changes

The strongest, and most obvious, motivator to induce NHCEs to contribute thereby raising the propensity that the Nondiscrimination Tests will be passed is to provide a generous matching contribution. However, a businesses' profitability is a large factor in determining whether such a contribution is feasible. [See J. Simons and V. Gieseke, "10 Steps If Your 401(k) Plan Fails Nondiscrimination Testing" Society for Human Resource Management (2009) [hereinafter "10 Steps Article"]].

In addition to an increased matching contribution, other "employee-friendly", plan design changes can be made to a plan to make it more appealing for employees to participate. For example, a plan can provide for relatively short eligibility and/or entry date requirements. [See A. Scialabba "Strategies for increasing 401(k) participation" CCH Benefit Plan Compliance TM, Vol. 4, Issue No. 6 (2000)]. It can also implement a lenient vesting schedule or offer easy access to plan assets through loans, in-service distributions based on attaining a certain age (e.g., age 59½) or hardship distributions.

C. Safe Harbor Contribution

Another way in which failures of the Nondiscrimination Tests may be avoided is for a plan sponsor to implement a "safe harbor contribution" feature in a plan. This feature generally allows a plan to automatically pass the Nondiscrimination Tests if specific contribution, vesting, and participant notification requirements are met.

There are two types of safe harbor contribution features: a safe harbor profit sharing contribution feature and a safe harbor matching contribution feature. The profit sharing feature requires that an employer nonelective contribution be made to NHCEs in an amount equal to three percent of their compensation.

With regard to the amount of employer matching contributions, the following scenarios will generally satisfy safe harbor matching contribution requirements:

1) Basic match: A 100% match on an eligible employee's deferral up to 3% of annual compensation and a 50% match on the next 2% of the employee's deferrals.

2) Enhanced match: A matching contribution that's at least as generous as the basic match at any level of an employee's deferral. For example, eligible employees may receive a 100% match on deferrals up to 4% of their annual compensation.

Safe harbor contributions must always be 100% vested. Therefore, these contributions are not returned to the employer upon termination of employment.

In addition to following plan provisions and other standard operational compliance rules, employers must:

1) adopt a 401(k) plan or amend their current 401(k) plan document to include safe harbor provisions, and

2) notify participants about safe harbor contribution provisions 30 to 90 days before the start of each plan year (Initially, this notice also must be provided to newly eligible employees.).

In addition to automatically passing the Nondiscrimination Tests, safe harbor contribution provisions can help:

1) reduce plan maintenance by eliminating

the need to perform the tests and the obligation of maintaining a vesting schedule,

2) maximize deferrals for HCEs, and

3) provide additional employee benefits with profit sharing contributions or matching contributions.

D. Top-paid Group Election

As mentioned above, the Nondiscrimination Tests examine the percentage of either elective deferral contributions or matching contributions that a participant receives when compared to the participant's compensation for the group of employees at issue (i.e., HCE or NHCE). If too much disparity exists in either of the tests, then the test at issue will not be satisfied. Thus, if the compensation for the group of HCE employees is increased, the percentage of either elective deferral or matching contributions in relationship to such compensation will decrease. In this situation, it would be helpful to a plan sponsor to limit the group of HCEs to the highest earning HCEs. This can be accomplished through the use of a "top-paid group" election.

A top-paid group election can limit the number of HCEs for purposes of applying the Nondiscrimination Tests. If an employer has made the top-paid group election in its plan document (either adoption agreement or basic plan document), employees treated as HCEs on the basis of their compensation are limited to the highest paid 20% of all the employees of the employer in the preceding plan year.

In general, to determine the number of employees that represent the highest paid 20% of all employees, the following employees in the preceding plan year may be excluded:

1) employees with less than six months of service,

2) part-time employees who normally work less than 17½ hours per week,

3) seasonal employees who work less than six months per year (an employee who works on one day during a month is deemed to have worked during that month),

4) employees who are under age 21, and

5) certain union employees.

However, while these employees may be excluded for the purpose of determining the number of employees in the top-paid group, the employees must be included when determining the actual members of the top-paid group.

A top-paid group election works well when there is a significant number of employees who barely exceed the "$120,000 HCE" threshold in the prior year who make a relatively large amount of elective deferral contributions to a plan. This is because such employees will be considered to be NHCEs. The election also works well when the highest paid HCEs are not making a relatively large amount of elective deferral contributions to a plan. This is because such employees will be considered to be HCEs by themselves.

E. Employee Education Program

As mentioned above, the more salary that NHCEs defer into a retirement plan, the greater the propensity that the Nondiscrimination Tests will be satisfied. One way that the percentage of elective deferral contributions for the group of NHCEs can be increased is by enhancing a retirement plan's employee education program. The following are some of the ways in which this can be accomplished:

1) employee education meetings could be held more often,
2) meeting times could be better advertised,
3) held on a mandatory basis (even perhaps during working hours), and/or

4) on a one-to-one basis.

In addition to the mechanics of employee education meetings, the substance of the meetings may be improved. For example, the benefits of making elective deferral contributions on a pre-tax basis or receiving matching contributions could be stressed. The overall necessity for retirement saving could also be emphasized.

To improve the employee education program in connection with the plan, a plan sponsor should discuss this matter with the plan's investment adviser and/or record keeper.

F. Choose a Record Keeper that Offers a 'User Friendly' Participant System

To enhance participation by NHCEs, an employer should also consider working with a record keeper which provides a "user friendly" system for plan participants. Such a system should provide a record keeping "dashboard" that is simple for employees to use to enroll and to adjust deferral amounts and investments. In addition, studies show that if plan participants are presented with a large array of investment alternatives, they become overwhelmed and their participation rate drops. [10 Steps Article]. Thus, investments that do not require a significant amount of monitoring (e.g., target date funds) should be considered. [Id.]

G. Prior Year Testing

If a plan sponsor knows before the end of a plan year that the Nondiscrimination Tests will be failed, this can cause the plan sponsor to take measures to generally ensure that the tests will be satisfied. This can be accomplished through the utilization of "mid-year" testing. However, until a plan year is finished, a plan sponsor will not know definitively how its 401k plan will fare under the tests. One way to obtain a definitive knowledge of the nondiscrimination testing results is to use "prior year" testing. The following discusses this concept.

The Code permits two methods of testing for nondiscrimination in connection with a retirement plan. The first method is "current year" testing where current year deferral and contribution percentages are used to compare the percentages of both HCEs and NHCEs.

The other method is prior year testing where the deferral and contribution percentages for NHCEs in the prior year are compared with HCE deferral and contribution percentages in the current year. The mechanics of prior year testing are as follows. In the first year of a 401(k) plan, or the first year 401(k) provisions are effective in an existing plan, a special rule applies since there are no prior percentages to use for the test. The employer can assume a prior year percentage for the NHCEs of 3% for purposes of the Nondiscrimination Tests or use the actual results of the first year's test. The second year, the maximum HCE percentage will be based on the NHCE percentage from the first year. At the end of the second year, the test will be performed which will be used for two purposes:

(1) The average HCE percentage will be compared to the maximum permitted average percentage (based on the NHCE percentage from the first year) to verify that the maximum was not exceeded, and

(2) The NHCE average percentage will be used to determine the maximum average HCE percentage for the third year.

The prior year testing method gives employers the limits in connection with the Nondiscrimination Tests for the HCEs in advance, which reduces the chance of a failed test at year end and the need for taxable refunds or other corrective measures.

If a plan sponsor would like to know in advance the limits that will be imposed once the nondiscrimination testing is complete, it can advise affected HCEs to reduce the amount of elective deferral contributions to minimize their refunds, or, if it appears that failures of the Nondiscrimination Tests may be a trend, to prepare the HCEs that refunds may be made in future years.

H. Testing Methodologies

There are different ways in which the Nondiscrimination Tests can be performed. The typical plan sponsor would probably not be aware of these methodologies. However, a retirement plan professional who specializes in third-party administration may be able to apply various alternative methodologies to cause a plan to pass the tests. Thus, it makes sense for a plan sponsor to seek out trained and experienced professionals who specialize in the performing the Nondiscrimination Tests.

III. Establish a Non-qualified Deferred Compensation Plan

Failures of the Nondiscrimination Tests can be reduced or avoided in their entirety if an employer implements a "non-qualified deferred compensation" plan ("Non-qualified Plan"). This type of plan allows eligible employees to set aside a portion of their salary on a pre-tax basis for the purpose of saving for retirement. A Non-qualified Plan can also accept employer contributions. Participants of such plans will generally pay federal and state income taxes when funds are made available to them.

A Non-qualified Plan is established primarily for a select group of management or "highly compensated" employees (although not necessarily the same as "HCEs" for purposes of tax-qualified retirement plans). An employer determines the employees eligible to be in the group.

A Non-qualified Plan is not subject to the Nondiscrimination Tests. In addition, if the plan is structured correctly, it is not subject to most of the rules of the Employee Retirement Income Security Act of 1974, as amended. For example, there is no "Form 5500" requirement with regard to the plan.

A Non-qualified Plan can be structured on a "defined contribution" plan basis. Thus, each participant of the plan can have an account with the plan similar to a 401k plan account.

It is important to note that, in general, any salary deferred or money contributed to a Non-qualified Plan must at all times be held in the general account of the employer and subject to its general creditors. This is obviously a major downside of the plan from the perspective of an employee.

There is also an adversity to an employer which sponsors a Non-qualified Plan. This is the fact that, unlike a tax-qualified plan, the employer's deduction for contributions made to the plan is generally delayed until the employee can obtain the accrued benefits of the plan. In addition, any money put aside to pay for the promised benefits of the plan is generally considered to be retained earnings to an employer and taxed as such.

IV. Conclusion

From what has been discussed, failures of the Nondiscrimination Tests can cause adversities for an employer and/or its HCEs. However, with careful planning and the utilization of retirement plan professionals, these failures can be avoided.

Protecting a Plan Fiduciary Through Obtaining Insurance Coverage

By Anthony L. Scialabba, Esq.

An employer that sponsors a retirement plan or a fiduciary may generally insure any fiduciary, including himself/herself, against costs, damages, expenses and liabilities reasonably incurred or imposed in connection with claims made against such fiduciary or in which the fiduciary may be involved by his or her position as a fiduciary. However, sometimes plan sponsors fail to do this.

Often the reason why the insurance at issue is not obtained is because plan sponsors believe that fiduciaries are indemnified because the "10% ERISA bond" covers breaches by fiduciaries. However, the bond only protects the assets of a plan and not the fiduciaries. Another reason why fiduciaries fail to obtain the insurance at issue is

because they mistakenly believe that their D&O or E&O policies cover them in this regard. However, these policies rarely provide insurance for "ERISA" claims.

In general, a fiduciary is anyone who has any discretionary authority or control over the disposition or management of plan assets. Moreover, a trustee of a retirement plan is per se a fiduciary. Thus, if an individual(s) meets these aforementioned requirements, he or she will be held to the status of a fiduciary of a retirement plan in his or her individual capacity. Therefore, an employer should consider purchasing ERISA fiduciary insurance that covers this person(s). An employer's insurance agent should be able to find an appropriate policy of insurance in this regard.

If a fiduciary policy of insurance is purchased, it should be reviewed. For example, a policy in this regard should be examined to ensure that it covers the correct individual(s) at issue, is in a sufficient amount, and covers the person(s) being insured for an appropriate amount of time.

Welcome to Jana Willey

We are pleased to announce that Jana Willey recently joined the Retirewell team as a Retirement Plan Administrator. Prior to joining Retirewell, Jana worked as an administrator for eight years. During her career as an administrator, Jana moved her way up to office management position where she was responsible for overseeing the billing department, conducting payroll, delegating tasks, managing schedules and addressing any customer concerns. In addition to working as an office manager, Jana attended business classes in the evening to further her education. She recently graduated from Rutgers School of Business with a B.S. in Business Administration. She is excited to use her administrative and leadership skills in the Retirement Plan Industry.

Jana lives in South Jersey with her partner and two cats.

Welcome to Christine Jeppi

RetireWell Administrators welcomes Christine Jeppi as the Financial Office Administrator with the primary responsibility of processing payrolls and qualifying distributions/loans with the plan's contract. Prior to joining RetireWell Administrators, she worked in the financial industry for 16 years with Annuities, IRAs, and Mutual Funds and six years in retail services. As a financial service professional, she built her career in customer service, processing, problem resolution, quality audit, correspondence, presentations, and project management. Her diverse skills and competencies derived from building relationships, improving processes, and focusing on all clients. Her strong work ethic, professional demeanor, and great initiative quickly promoted her to new endeavors, built relationships, and to take ownership of diverse projects. She graduated from Penn State University with a B.A. in Speech Communication.

Christine lives in Burlington, NJ with her husband and two young sons.

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