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Perspectives

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Required Testing in Qualified Retirement Plans and Solutions to Consider

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This time of year retirement plan providers are gearing up to complete the annual Actual Deferral Percentage (ADP) tests for qualified retirement plans. This test in particular can be very impactful to certain plan participants. This is a non-discrimination test for 401(k) plans mandated by the IRS to ensure that a plan does not unduly benefit highly compensated employees (HCE) at the expense of other employees. It is one of many tests in the suite of compliance testing that Greenleaf Trust prepares on behalf of many of our clients. Under the ADP testing rules, the average employee contributions (both pre-tax salary deferrals and Roth 401(k) contributions) of the highly compensated employees and non-highly compensated (NHCE) employees are calculated and compared on an annual basis based on the plan year.

> "This is a non-discrimination test for 401(k) plans... to ensure that a plan does not unduly benefit highly compensated employees (HCE) at the expense of other employees."

To pass the test, the ADP of the HCE group may not exceed the ADP for the NHCE group by 1.25 percent or 2 percentage points. If the plan fails the ADP test, corrective action must be taken to protect the qualified status of the plan arrangement. The law and related regulations provide various methods for correcting failures during a "correction period." This statutory correction period is the 12-month period following the close of the plan year in which the failure occurs. If corrective distributions are made after the first 2 ½ months of the correction period, the employer (not the HCE) is liable for excise tax. If correction is not made within the correction period, the plan is considered disqualified. In essence, however, it is important to note that there is no inherent problem with failing the test as long as corrective action is taken within the proper time frames.

Failing this test can inhibit employee contributions to a 401(k) plan by individuals who meet the criteria and are considered highly compensated. Receiving a distribution of previously deferred compensation dollars including any gains or losses is not well received by most individuals who may be impacted following an ADP test failure. There are steps that a plan sponsor can take to avoid this requirement or improve the outcome.

One solution to this problem is to incorporate a safe harbor provision to the plan. This option, while adding costs, would alleviate the requirement for completing the annual ADP test, thus allowing all HCE's to defer the maximum amount allowed by law and no returns of contributions would be required. There are two basic options for a safe harbor contribution provision.

1) 3% Safe Harbor Non-Elective Contribution
2) Basic or Enhanced Safe Harbor Matching Contribution

The first option requires a 3% mandatory employer contribution to all eligible participants based on compensation. Some things to consider regarding this option include:

c) All participants who have met the plan's definition of eligibility share in this contribution regardless of whether they terminate within the plan year or work less than 1,000 hours.
d) The Safe Harbor Non-Elective Contribution source is immediately vested in the participant's account (cannot attach a vesting schedule).
e) Generally, the 3% Safe Harbor Non-Elective Contribution may satisfy a top heavy mandatory contribution requirement.

f) This contribution can be easier to budget as it is a straight percentage of compensation.

The second option requires a matching contribution which is composed of different tiers based on the Basic or Enhanced design. A few things to consider with this option are:

a) The Safe Harbor Matching Contribution is only made for those participants who are contributing pre-tax salary deferrals or Roth 401(k) dollars into the plan.
b) Participants who contribute would share in the Safe Harbor Matching Contribution regardless of whether they terminate within the plan year or work less than 1,000 hours.
c) The Safe Harbor Matching source is also immediately vested in the participant's account (cannot attach a vesting schedule).
d) This contribution may not satisfy any top heavy mandatory contribution.
e) This contribution is more difficult to budget as costs could potentially be high if everyone participates in the plan to the fullest extent.

The typical safe harbor match is 100% of salary deferrals up to 3% of compensation deferred plus 50% of salary deferrals up to the next 2% of compensation deferred.

"Both... safe harbor contribution options require a plan amendment and an annual notice which must be provided to all employees..."

Both of these safe harbor contribution options require a plan amendment and an annual notice which must be provided to all employees no later than 30 days prior to the event. Ongoing, on an annual basis, a plan sponsor must declare that the plan will be a safe harbor design.

Another solution to the problem of failing the annual non-discrimination test is adding an auto enrollment feature to the plan. With proper documentation and notification to plan participants, this feature allows a plan sponsor to automatically deduct an allowable percentage from a participant's compensation into the plan. Auto escalation is also permitted which allows an automatic increase annually of generally one percent. This option is beneficial in multiple ways. It helps an employee to start saving in a qualified retirement plan and to secure a retirement benefit in retirement. Last, by automatically enrolling plan participants into the plan, the deferral rate for those not previously participating will increase and, over time, likely lessen the effects of the failure or remove the failure component entirely.

Our Retirement Plan Division within Greenleaf Trust would be happy to discuss these options with you at any time. Please contact us for more information.