UPDATE

Employee Benefit News for
The Cooperative Industry

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Nondiscrimination Testing Basics

The Internal Revenue Service and Department of Labor require qualified retirement plans that allow employees to make elective deferrals into the plan through a Pre-tax or Roth arrangement must test employee contributions, on an annual basis, to ensure that Highly Compensated Employees (HCEs) are not benefitting from the plan to a higher degree than Non-Highly Compensated Employees (NHCEs). This test is called the Average Deferral Percentage or ADP test. Additionally, similar tests are required on any matching and after tax contributions in the Average Contribution Percentage or ACP Test.

In all cases, the HCEs must be identified. For 2018, the IRS defines a Highly Compensated Employee as any employee who earned more than $120,000 in the prior plan year, or is a more than 5% owner, regardless of compensation, in the current or prior plan year. (It is important to note that the HCE limit is indexed annually and may change in the future).

Next in the process, the actual deferral rate for each eligible employee must be calculated. This is done by taking the employees total deferrals (less age 50+ catch up contributions) and dividing that by the plan compensation for that employee.

Third, an average the deferral rates for each group – HCEs and NHCEs is determined.

Lastly, a comparison is made between the average deferral percentage for the HCEs and NHCEs. IRS regulations dictate that the HCE group's average deferral percentage must not exceed the <u>lesser</u> of 2 times the NHCE ADP or 2% plus the NHCE group's average deferral percentage. For example, if the NHCE group ADP is 4%, the ADP for the HCE group can be no greater than 6% to pass the ADP test. Or if the NHCE group ADP is 1.98%, then the HCE group can be no greater than 3.96% to pass the test. In the second example, 3.96% (two times the ADP of the NHCEs) is used because it is the lesser than what the ADP would be if adding 2% which would have given an ADP of 3.98%.

So – what happens if your plan doesn't pass the ADP or ACP tests? Don't worry – all is not lost! There are ways out of the maze. The IRS regulations indicate that plans that do not pass the ADP or ACP tests will need to either provide additional employer contributions to NHCEs, or alternatively refund excess contributions to HCEs. The latter is the most common practice.

There are a few items to note about refunds. While both the ADP and ACP tests are performed and calculated based on percentages, the refunds are made to

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participants based on dollars contributed. Refunded amounts must be adjusted for earnings during the plan year, and are taxable to the participant in the year of distribution.

Refunds for ADP or ACP failures need to be completed within 2 ½ months following the end of a plan year in order to avoid a 10% excise tax on the plan sponsor. This excise tax, if applicable, is payable to the IRS, and is based on the excess contribution amount.

Many plan sponsors and HCEs view failing an ADP test (and receiving a refund) negatively. Some even choose to limit the HCEs' deferral rates during the year to an amount that they think will allow the plan to pass these tests. However, others view these refunds as confirmation that an HCE was allowed to defer the absolute maximum that they could during the plan year. No matter how one looks at it, it is important to understand the overall testing process.

As stated above, current IRS regulations make ADP or ACP refunds taxable to the participant in the year that they are distributed, not in the plan year that the deferrals were made to the plan. This eliminates the need for HCEs to hold their tax returns until all testing is completed.

If you are a plan sponsor who is concerned about your HCEs receiving refunds, another alternative to explore with your Relationship Manager is structuring a design-based Safe Harbor 401(k) Plan. Under this arrangement, if the plan provides certain minimum contribution and vesting requirements, ADP/ACP tests can be avoided all together, allowing your HCEs to contribute up to the maximum contribution limit each year.

There are a few options when it comes to traditional Safe Harbor plan designs:

1. A 3% safe harbor non-matching contribution
2. A basic safe harbor match of 100% up to 3% of compensation and 50% of the next 2% of compensation.
3. An enhanced safe harbor match formula. The enhanced safe harbor match must meet the following requirements: It must be at least as generous as the basic match.

These safe harbor contributions must be 100% vested immediately. If you are interested in learning more about the benefits and additional requirements of adding a Safe Harbor provision to your plan, please contact your Milliman Relationship Manager.

Accurate and complete data is essential to the administration and testing of any retirement plan. Accurate data makes the maze much more manageable. This is why Milliman requests plan sponsors to confirm data annually for each participant in your plan in addition to completing the annual questionnaire. Both of these pieces provide us valuable information about your employees and your plan.

Please contact your Relationship Manager if you have any questions regarding nondiscrimination testing and the Co-op 401(k) Plan or call 1.800.652.6675.