Discrimination Testing

For this section *HCE = Highly Compensated Employee* and *NHCE = Non-Highly Compensated Employee*.
HCE is defined as those employees who are more than 5% owners, or those employees whose total compensation exceeded a certain threshold in the prior year ($130,000 in 2020 for 2021 testing purposes).

ADP/ACP

The Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests are two types of annual non-discrimination tests that 401(k) plans must pass in order to keep their qualified status under IRS rules and the Employee Retirement Income Security Act (ERISA). Both are conducted to make sure 401(k) plans don't unduly benefit highly compensated employees at the expense of other employees. The ADP and ACP tests must be passed in order to satisfy the non-discrimination requirements of the IRS if the plan is to continue.

If the plan fails either test, the employer must take corrective action to protect its qualified status in the 12-month period following the close of the plan year in which the oversight occurred. Failure to do so can result in the IRS imposing penalty fees, plan disqualification, and fiduciary liability on the part of the employer.

How it Works

The ADP test compares the average salary deferral percentages of highly compensated employees (HCE) to that of non-highly compensated employees (NHCE).

The ADP test takes into account both pre-tax deferrals and after-tax Roth deferrals, but not catch-up contributions.
To pass the test, the ADP of the HCE may not exceed the ADP of the NHCE by more than two percentage points. In addition, the combined contributions of all HCEs may not be more than two times the percentage of NHCE contributions.
The ACP test uses a similar method as the ADP test, except that it uses matching contributions or employee after-tax contributions.

Correcting an ADP/ACP Test Failure

When employers fail the ADP/ACP tests, they can remedy the failure by refunding excess contributions back to HCEs in the amount necessary to pass the test. However, these refunds will be liable for income tax for the HCE individuals.
In lieu of refunds, the employer can make a contribution called a Qualified Non-Elective Contribution to the non-highly compensated employees in an amount necessary to raise the NHCE average up enough to pass testing. The Benefit Advantage can provide an analysis of both options, so you can choose which option works best for your situation.

PARTICIPATION AND COVERAGE TESTING

401(b) coverage testing is a "counting" form of testing, where you are basically comparing the ratio of the number of HCEs who benefit under the plan to the total number of statutorily eligible HCEs, to a similar ratio of NHCEs. The ratio of NHCEs benefiting must equal or exceed a stated percentage of HCEs benefiting (70% in the standard test, but lower ratios are permitted to satisfy more complex alternate tests) in order for the coverage test to pass. There are "safe harbor" designs that can be used so that such testing is automatically passed without a requirement for these complicated calculations to be performed.

DEDUCTION LIMITATION

Employers can deduct contributions to retirement plans of up to 25% of total employee compensation. The IRS defines what types of compensation can be used for this purpose, and it imposes limits on the amount of compensation that can be used. The Benefit Advantage will calculate the maximum allowable employer contribution for you each year.

TOP-HEAVY TESTING

What is the Top-Heavy Test?

Each plan year, it must be determined whether your 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:

- an officer of the employer with compensation greater than the amount under section 416(i)(1)(A)(i). This amount is $185,000 for 2021 (subject to cost-of-living adjustments); or
- a more than 5% owner (and family members) of the employer, as defined in section 416(i)(1)(B)(i) of the Internal Revenue Code; 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 (i.e., for a calendar year plan, December 31, 2020 is the determination date for the 2021 plan year).

For new plans – The determination date is the last day of the current plan year (i.e., December 31, 2021 is the determination date for a calendar year 2021 plan year). This means that for new plans, you may not know your plan will be top-heavy until after the plan year is completed.

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.

Moving forward, a strategy to resolve the top-heavy issue could be as simple as a more appropriate Safe Harbor plan design. The Benefit Advantage can assist you in reviewing your plan design to determine if a change is required.