RETIREMENT PLAN CONSULTING

Fiduciary Compliance Alert

Gallagher

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Nondiscrimination Testing Applicable to Qualified Retirement Plans

The first calendar quarter typically is the busiest time of year for service providers who run nondiscrimination tests on qualified retirement plans. Most plans run on a calendar year basis, and testing must be complete by March 15 to avoid certain excise taxes. In January, plan administrators provide the recordkeeper with the annual information necessary to run the tests, and rush to meet the deadline.

This article describes in general terms the types of nondiscrimination tests applicable to qualified defined contribution retirement plans, and when they must be run. As a rule, nonqualified deferred compensation plans are not subject to these nondiscrimination tests. Specific questions regarding your plan's required testing should be directed to your Gallagher retirement plan consultant, or your plan's recordkeeper.

Highly Compensated Employees. Before we can understand the basic nondiscrimination tests that apply to qualified retirement plans, we need to understand the concept of highly compensated employees (HCEs). Most of the applicable nondiscrimination tests compare contributions of HCEs to the contributions of non-highly compensated employees (NHCEs). An employee is an HCE for a plan year if they meet either a five-percent owner test or a compensation test. The employee is an HCE even if they satisfy only one of the two tests.

Under the five-percent owner test, the employee is an HCE if they own more than 5% of the plan sponsor at any time during the current plan year or the 12 months preceding the plan year. Under the compensation test, the employee is an HCE if their compensation during the 12-month period preceding the plan year is more than $155,000 (for 2024). The compensation amount is indexed each year for inflation. The plan sponsor may (but is not required to) elect to limit the number of employees who can be treated as satisfying the compensation test to the top 20% of employees (based on compensation). Any employee that does not meet one of the two HCE tests will be classified as an NHCE.

Coverage Testing. The coverage test considers how many HCEs benefit for the plan year as compared to how many NHCEs benefit. The purpose of the coverage test is to help ensure that the plan allows enough NHCEs to participate. If all HCEs are allowed to participate, but the plan document excludes most of the NHCEs, the plan will have trouble passing the coverage test. An employee can be eligible to participate while actually not contributing to the plan. For example, suppose an employee is eligible to defer into a 401(k) plan and receive a match, but chooses not to defer. That person is treated as benefiting for purposes of the coverage test, even though they actually did not elect to make 401(k) deferrals and therefore did not receive any matching contributions.

A plan has two alternatives for passing the required coverage test. The first alternative is the Ratio Percentage Test. The Ratio Percentage Test is satisfied if the proportion of NHCEs eligible for the plan is at least 70% of the proportion of HCEs eligible for the plan. If the plan does not pass the Ratio Percentage Test, it will need to run the much more complicated Average Benefits Test.

Actual Deferral Percentage (ADP) Testing and Actual Contribution Percentage (ACP) Testing. ADP testing applies to the elective deferrals – both pre-tax and Roth – made in 401(k) plans. (403(b) plans and governmental 457(b) plans are exempt from the ADP test.) ACP testing applies to matching contributions, and traditional after-tax contributions if permitted, in 401(k) and 403(b) plans. (Governmental 457(b) plans are exempt from the ACP test.)

The ADP test calculates the overall deferral ratio (based on compensation) for both HCEs and NHCEs. For the NHCE group, the test can use either the ADP ratio from the current year or the prior year. The test passes if the HCE ADP ratio is no higher than 125% of the NHCE ADP ratio. Alternatively, the test also passes if the HCE ADP ratio does not exceed the lesser of (1) 200% of the NHCE ADP ratio, or (2) the NHCE ADP ratio plus 2%. The ACP test is run using the same guidelines, but looking at the average contribution percentage ratios for the matching and traditional after-tax accruals for both the HCE group and the NHCE group.

Rate Group Testing. The rate group test focuses on the nonelective contribution source. The purpose of the test is to help ensure that NHCEs are getting a nondiscriminatory allocation of the nonelective contribution as compared to the plan's HCEs. The rate group test need not be run if the plan allocates the nonelective contribution to each eligible participant in a manner that is pro-rata to the participant's pay. For example, if all eligible participants get a nonelective contribution of 3% of their compensation for the plan year, the rate group test need not be run. Similarly, the plan can avoid the rate group test if each participant gets the same flat dollar amount. When the plan allocates the nonelective contribution as a different rate of compensation to different groups of participants, the plan must run the rate group test.

The Treasury regulations have a number of different ways to pass the rate group test. Each method is a complex mathematical test. Perhaps the most common method requires the plan to create "rate groups." The test sets up a different rate group for each HCE. Each rate group includes all participants that receive an allocation (calculated as a percentage of compensation) that is equal to or greater than the allocation rate given to the HCE. Each rate group must then satisfy one of the coverage testing methods as described above. Another method of passing the rate group test (known as cross-testing) requires the plan to convert each participant's accrual during the year to the amount of benefit they will eventually receive at retirement, and test based on the benefit instead of the actual allocation amount.

Contribution Limit Testing. The Code subjects participants in defined contribution plans to a limit on the amount of 401(k) contributions that they may contribute each year. In general, a participant can only defer a maximum of $23,000 (for 2024). If the participant is 50 or older, the plan document can allow them to defer an extra $7,500 (for 2024) for the year. The maximum deferral amount is commonly referred to as the participant's 402(g) limit. These limits are indexed each year for inflation. Both pre-tax deferrals and Roth deferrals count toward the maximum limit each year.

In addition to the limit on elective deferrals, the Code imposes an annual contribution limit on participants in defined contribution plans. The overall limit is commonly referred to as the 415 limit. A participant's total annual additions cannot exceed $69,000 for 2024. The limit is indexed each year for inflation. All contributions during the year will count toward the participant's 415 limit, including pre-tax and Roth deferrals, matching contributions, nonelective contributions, traditional after-tax contributions and any reallocations of forfeitures from other accounts. Earnings on assets in the participant's account do not count toward their 415 limit.

Top-Heavy Testing. Top-heavy is the one test that is not based on a comparison of HCEs to NHCEs. Rather, the top-heavy test compares account balances of key employees to the account balances of non-key employees. There are three ways in which a participant can become a key employee. First, any employee that owns more than 5% of the plan sponsor is a key employee. Second, any employee that owns more than 1% of the plan sponsor and receives more than $150,000 in compensation for the year is a key employee. Finally, key employees will include any officer of the plan sponsor that earns more than $220,000 for the year (in 2024). The $220,000 compensation requirement for officers is indexed for inflation. Any employee that does not meet one of those standards will be a non-key employee.

A plan is top-heavy when the key employees own more than 60% of the value of the plan assets. This ratio is tested every year based on the account balances on the last day of the prior plan year. The employer must generally pay a minimum 3% benefit to all non-key employees if the top-heavy ratio exceeds 60%. The top-heavy test frequently creates more concern for smaller plans and for new start-up companies.

Benefits, Rights & Features Testing. Retirement plans cannot offer any benefits, rights and features in a discriminatory manner. The term "benefits, rights and features" includes such things as distribution triggers, medium of distributions (e.g., in cash vs. in kind), rates of matching contribution and the right to specific investments among other things. When a benefit, right or feature is offered to some participants, but not all, the plan must run the benefits, rights and features test.

The benefits, rights and features requirement entails two separate tests. The plan must pass both parts to satisfy the benefits, rights and features rule. First, the plan must pass a current availability test. This involves a complex nondiscriminatory classification test comparing the number of HCEs that have access to the benefit, right or feature to the number of NHCEs that have access. Second, the plan must also pass an effective availability test. Unlike the current availability test, effective availability does not involve a specific mathematical test. To pass the effective availability test, the group of participants that has access to the benefit, right or feature cannot substantially favor HCEs, based on all the facts and circumstances of the case.

Compensation Ratio Testing. Compensation ratio testing can apply when the plan document uses a non-safe harbor definition of compensation. The plan document can exclude welfare benefits, fringe benefits, moving expenses, deferred compensation payments and expense reimbursements from the definition of compensation without triggering the compensation ratio test. Other exclusions from compensation – such as commissions, bonuses or performance based pay – can trigger a need to run the compensation ratio test. The purpose of the test is to prevent the plan sponsor from carving out certain types of compensation in a way that would disproportionately benefit HCEs.

Unlike other nondiscrimination tests, the compensation ratio test does not have a specific mathematical formula to determine whether the plan passes. The test requires the plan administrator to calculate the ratio of overall compensation that is included for plan purposes with respect to HCEs. The overall compensation that is included for plan purposes with respect to NCHEs must then be calculated and compared to the HCE ratio. If the HCE's ratio of included compensation exceeds the NHCE's ratio by more than a "de minimis" amount, the test will not pass.

However, for 401(k) plans, if the nondiscrimination test on deferrals (the ADP Test discussed previously) is conducted on a safe harbor definition of compensation (such as total gross compensation), the Compensation Ratio Test is deemed to pass.

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The nondiscrimination tests are designed to prevent the plan sponsor from providing very generous benefits to HCEs while giving a lower level of benefits to NHCEs. As indicated above, the types of tests that apply to a given defined contribution plan will depend upon the type of contributions made to the plan, as well as other plan design features. Plan sponsors should work closely with their Gallagher consultants and recordkeepers to determine which nondiscrimination tests will apply, and whether or not the plan passes the relevant tests for a given plan year. Plan design can sometimes help or hinder nondiscrimination testing, so a plan review is beneficial if your plan is having nondiscrimination testing problems.

[1] The IRS requires that, if a plan elects to limit HCE status to the top 20% of employees by compensation, this election must apply to all plans within the controlled group, including non-retirement plans (e.g. cafeteria plans).

