

## Employee Benefits Plan Newsletter

# Non-Discrimination Testing for Qualified Defined Contribution Retirement Plans

Sponsors of certain defined contribution plans, namely 401(k) and 403(b) plans, need to be aware that these plans are subject to nondiscrimination tests known as the Actual Deferral Percentage (ADP) test and the Actual Contribution Percentage (ACP) test. The ADP test involves reviewing the amount of contributions made to the plan by employees through a salary deferral arrangement, while the ACP test measures the level of employer matching contributions made in relation to the salary deferrals.

Section 403(b) plans are only required to perform the ACP test since these plans are subject to the Universal Availability rule, whereby the employer generally must make the plan available to employees. (i.e., allow virtually all employees to contribute to the plan).

Safe harbor plans are not required to perform these tests, provided they meet certain criteria in terms of employer contribution formulas and vesting.

Non-safe harbor plans must perform the ADP and/or ACP test annually in order to compare the average deferral rate and average contribution rate of Highly Compensated Employees (HCEs) versus Non-Highly Compensated Employees (NHCEs). HCEs are described as those having greater than 5% ownership in the entity sponsoring the plan, or with compensation at or above a stated amount — \$130,000 for the 2020 plan year. These tests are required in order to ensure that a plan does not unduly benefit HCEs at the expense of other employees.

### Timing

Testing should be completed within 2½ months after the close of the plan year. For a 2020 calendar year plan, this means the testing deadline is March 15, 2021. Failure to timely perform the ADP/ACP tests may create qualification issues if such testing results in a failure requiring correction. If the correction is made by distributing the amount of the excess contributions, and the distribution occurs after March 15 of the year following the year being tested, the excess amount will be subject to a 10% excise tax that is reported and paid to the IRS. The refunding of all or a portion of a HCE's deferred amounts will be required to be adjusted for earnings (which become taxable income to the HCE). In the case of a failed ACP test, the HCE may forfeit a portion of non-vested employer matching contributions.

Obviously, these unintended results for HCEs either warrant consideration for implementing a nonqualified plan to allow the HCE to contribute more than a nominal amount for retirement, or to increase the monitoring of plan contributions during the plan year to avoid these types of corrections.

### Other Compliance and Nondiscrimination Testing Required for Retirement Plans

In addition to the ADP/ACP tests discussed above, qualified retirement plans are subject to various other nondiscrimination tests to maintain compliance with IRS regulations. Some of the more common types are summarized below:

- **Top-Heavy Test** – Performed to determine if a plan’s Key Employees hold a disproportionate amount of a plan’s assets. Sixty percent or more of a plan’s assets held by Key Employees signifies that the plan is Top-Heavy, potentially requiring an additional employer allocation to Non-Key Employees.
- **IRC Section 402(g) Test** – Ensures that a plan is meeting the annual statutory limit for employee deferrals made to a plan (\$19,500 for 2020).
- **IRC Section 415 Test** – Ensures that the annual additions to a plan (the sum of employee and employer contributions allocated to a participant in a plan year) do not exceed the statutory limits for the year. For 2020, this limit is \$57,000.
- **IRC Section 410(b) Coverage Test** – The purpose of the test is to make sure a given plan covers enough [non-highly compensated employees](#). Each contribution type (employee and employer) is considered a separate plan. This test is especially important for retirement plans that offer a nonelective employer (e.g. profit sharing) contribution where certain allocation provisions may be required or where the allocation is determined on a tiered formula based on years of service.

## Contact Us

The Employee Benefit Services Group (EBSG) at PKF O’Connor Davies, LLP has extensive experience in the preparation and review of the requirements of the nondiscrimination tests, and other compliance matters. Plan administrators and fiduciaries are generally the responsible parties required to maintain the qualified status of a retirement plan. Third party administrators, consultants, and other benefit professionals typically perform these services for employee benefit plans.

Our EBSG team is comprised of former administrators, actuaries, and former IRS personnel who have many years of experience with the testing requirements. For information or questions about the testing for employee benefit plans, speak with your PKF O’Connor Davies contact or:

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