



NAFE 2017 NIPA ANNUAL FORUM & EXPO

LEARN. DISCOVER. GROW.

401(k) Plan Testing 101

*Kimberly B. Martin, APA, CPC, QPA
NIPA, Education Director
Bates & Company, Inc., Account Executive*

Kimberly B. Martin, APA, CPC, QPA
NIPA, Education Director
Bates & Company, Inc., Account Executive



As the Education Director of NIPA, Kim Martin is responsible for the leadership and strategic management of the association's educational programs. Kim is also an account executive at Bates & Company, Inc., providing administration and consulting services to clients.



Agenda

402(g) dollar limit

415(c) limit

Coverage testing

402(g) Deferral Limit

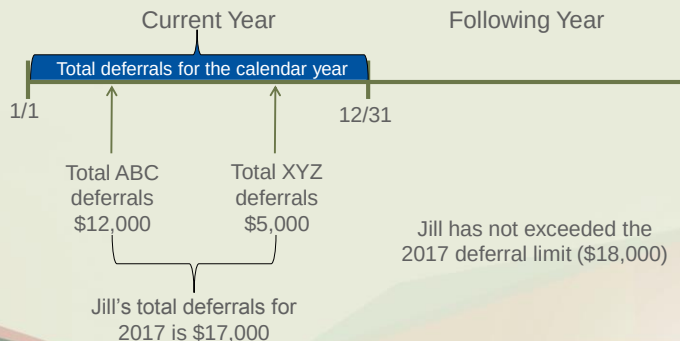
- Imposes a dollar limit on the amount of elective deferrals a participant may exclude from gross income
 - 2017 deferral limit = \$18,000
 - Individual *participant* limit – not a plan limit
 - Based on the *calendar year*
- Other possible limits on elective deferrals
 - Plan document (e.g., limited to 10% of compensation)
 - Statutory (e.g., IRC § 415, ADP test)

402(g) Deferral Limit

- Single limit for
 - All plans – 401(k) plan, 403(b) plan, SAR-SEP and SIMPLE IRA
 - All elective deferrals – pre-tax and designated Roth contributions
- Interplay with IRC § 401(a)(30)
 - To maintain its qualified status, a plan must limit elective deferrals to the 402(g) dollar limit
 - IRC § 401(a)(30) is a plan limit (qualification issue)
 - Plan administrator must monitor deferrals for the IRC § 402(g) deferral limit only for the employer's plan(s) (and plans of related businesses)

Example – 402(g) Deferral Limit

- Jill, age 45, works for 2 unrelated companies in 2017
 - Employee of ABC Company – defers \$12,000 to ABC 401(k) plan
 - Employee of XYZ Company – defers \$5,000 to XYZ 401(k) plan



Catch-Up Contributions

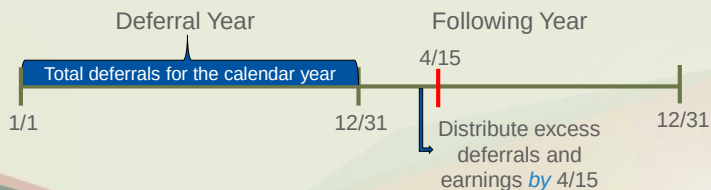
- Additional elective deferrals (IRC § 414(v))
 - Must be **50 or older** by the end of the calendar year
 - Deferrals are classified as catch-up contribution when
 - **Plan limit** is exceeded, or
 - **Statutory limit** is exceeded (§ 402(g), § 415, ADP test)
 - Optional provision; document will state if permitted
 - 2017 catch-up limit = \$6,000

Examples:

- Amy (age 50): defers \$24,000 during 2017
Exceeds 402(g) deferral limit of \$18,000
\$6,000 excess → catch-up
- Brad (age 57): defers \$12,000 (12% of pay)
Plan limits deferrals to 10% of pay (\$10,000)
\$2,000 excess → catch-up

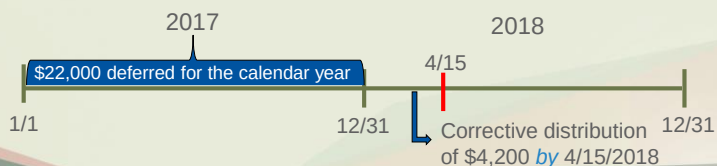
Correcting Excess Deferrals

- Distribute excess deferrals plus attributable earnings
 - Deadline
 - Statutory – by **April 15** following the calendar year of the excess
 - Plan – may establish an earlier date (e.g., March 1 of the following year)
 - Taxation
 - Year of deferral – excess deferrals are taxable (except Roth portion)
 - Year of distribution – attributable earnings are taxable



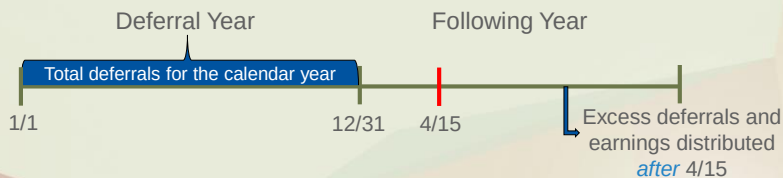
Example – Corrective Distribution of Excess Deferrals

- Cheryl (age 45) elects to defer \$2,000/month in 2017
 - Deferrals cease December 1, 2017
 - 2017 deferrals = \$22,000 (\$2,000 x 11 months)
 - Excess deferrals = \$4,000 (\$22,000 deferrals - \$18,000 limit)
 - Attributable earnings = \$200
 - Corrective distribution of \$4,200 was made on March 23, 2018
 - Taxation
 - 2017 = \$4,000 (excess deferrals)
 - 2018 = \$200 (earnings)



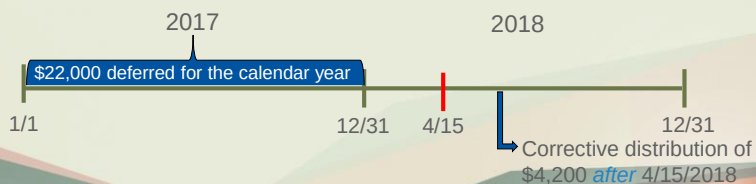
Correcting Excess Deferrals

- Corrective distributions not timely made by April 15
 - Impacts plan qualification under IRC § 401(a)(30)
 - Plan must follow the correction method under EPCRS
 - Distribute the excess deferral and attributable earnings
 - Year of deferral – excess deferrals are taxable (including Roth portion)
 - Year of distribution – attributable earnings *and* excess deferrals are taxable (including Roth portion)



Example – Corrective Distribution of Excess Deferrals

- Cheryl (age 45) elects to defer \$2,000/month in 2017
 - Deferrals cease December 1, 2017
 - 2017 deferrals = \$22,000 (\$2,000 x 11 months)
 - Excess deferrals = \$4,000 (\$22,000 deferrals - \$18,000 limit)
 - attributable earnings = \$200
 - Corrective distribution of \$4,200 made on *June 6, 2018*
 - Taxation
 - 2017 = \$4,000 (excess deferrals)
 - 2018 = \$4,200 (earnings *and* elective deferrals)



415 Limit

- IRC § 415(c) limits the maximum amount that can be allocated to a participant each year
- “Annual additions” are limited to the *lesser of*:
 - Compensation limit – 100% of compensation, or
 - Dollar limit – \$54,000 (indexed for 2017)
- Limit applies to *all* plans of an employer (and related employers)

Annual Additions

Include:

- Elective deferrals
- Designated Roth contributions
- Employer contributions
- Forfeitures

Do not include:

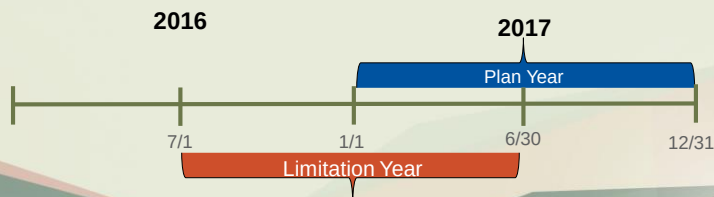
- Catch-up contributions
- Investment earnings
- Loan repayments
- Rollovers/transfers

415 Calculation Period: Limitation Year

- The 415 limit is calculated based on the limitation year
 - Generally the plan year
 - A different 12-month period can be defined in the document
- 415 dollar limit is the limit applicable to the year in which the limitation year ends

Example:

An employer with a calendar year plan establishes a limitation year of July 1st to June 30, which coincides with the employer's tax year



§ 415 Compensation

- The 415 limit is calculated based on § 415 compensation
 - Generally includes *all* of a participant's wages, salaries and fees actually paid during the limitation year
 - Full year* compensation is used even if the participant is not eligible to participate the entire plan year
 - Compensation is "*grossed up*" to include elective deferrals and catch-up contributions
 - Compensation is limited to compensation under IRC § 401(a)(17) (indexed to \$270,000 for 2017)

Example – 415 Limits for 2017

Participant	Compensation	Deferral	Match	Profit Sharing	Total Allocations	Excess Annual Additions
Dee	\$250,000	\$18,000	\$10,000	\$37,500	\$65,500	\$11,500
Evan	\$150,000	\$ 8,000	\$6,000	\$22,500	\$36,500	\$0
Fran	\$ 75,000	\$ 7,500	\$3,000	\$11,250	\$21,750	\$0
Gary	\$ 25,000	\$ 500	\$ 500	\$ 3,750	\$ 4,750	\$0
Hank	\$ 10,000	\$ 8,500	\$ 400	\$ 1,500	\$10,400	\$400

- Dee has exceeded the 415 dollar limit of **\$54,000** (indexed for 2017) by \$11,500
- Hank has exceeded the **100% of compensation** component of the 415 limit by \$400

Correcting Excess Annual Additions

- Failure to timely correct excess annual additions may result in plan disqualification
- EPCRS correction method
 - Distribute employee contributions
 1. Unmatched after-tax
 2. Unmatched deferrals
 3. Matched after-tax (apportioned between after-tax and match)
 4. Matched deferrals (apportioned between deferral and match)
 - “Hanging match” and non-elective contributions placed in a suspense account and used to reduce contributions in the current or next year

Correcting Excess Annual Additions

Correction principles

Distributions and forfeitures must include the excess *and* attributable earnings

The entire corrective distribution is taxable in the year *distributed*

Corrected amounts are *not* included in the 402(g) deferral limit or the ADP/ACP test

Example – Correction of Excess Annual Additions

Correction	Dee	Hank
Excess annual additions	\$11,500	\$400
Step 1: Distribute unmatched deferrals*	\$ 8,000 (remaining excess \$3,500)	\$400 (excess remaining \$0)
Step 2: Distribute matched deferrals*	\$ 1,750 (remaining excess \$1,750)	\$0
Step 3: Forfeit matching contributions*	\$ 1,750 (remaining excess \$0)	\$0

* Plus attributable earnings

- What if Dee and/or Hank are catch-up eligible?

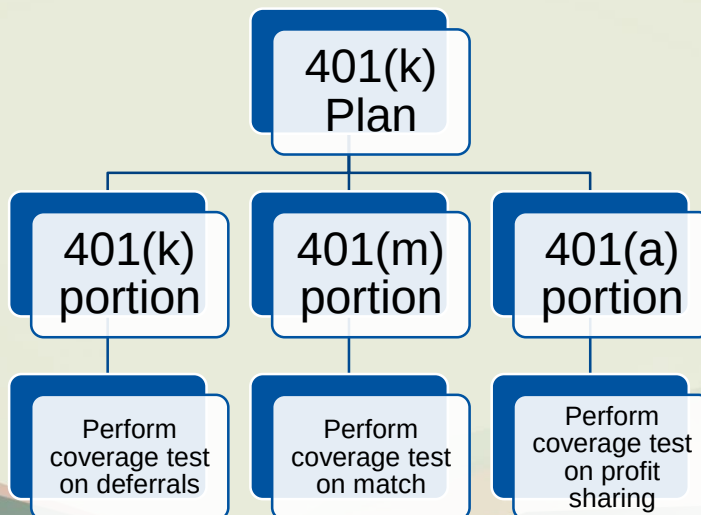
Coverage Test (IRC § 410(b))

- Minimum coverage requirements
 - Plan must benefit a nondiscriminatory number of NHCEs
 - Automatic pass!
 - Standardized prototype plan
 - Plan benefits only NHCEs
 - Plan has only HCE participants
 - Union plans
 - Annual testing
 - Ratio percentage test, *or*
 - Average benefit test

Mandatory Disaggregation

- Parts of a 401(k) plan must be tested separately from other parts of the plan
 - 401(k) plan
 - Salary deferrals, even if shifted to the ACP test
 - 401(m) plan
 - After-tax employee contributions
 - Regular matching contributions
 - QMACs, even if in the ADP test
 - Safe harbor matching contributions
 - Non-elective (“401(a)”) portion of plan
 - “Profit sharing” contributions
 - QNECs, regardless of ADP/ACP testing
 - Safe harbor non-elective contributions

Mandatory Disaggregation



For Each Disaggregated “Plan”

Identify HCEs

Determine testing group

Determine benefiting group

Perform coverage test

Determine the Testing Group

- **Includable** employees
 - Start with all employees of the employer who are employed at any time during the plan year
 - Common-law employees
 - Self-employed individuals
 - Leased employees
 - Employees of related employers
 - Certain employees may be excludable
 - Testing group = workforce – excludable employees

Determine the Testing Group

- **Excludable** employees
 - Have not met the plan's age and service requirements
 - Certain terminated employees
 - Union employees
 - Nonresident aliens

- **Example:**

	401(k) Portion	401(m) Portion	401(a) Portion
Eligibility Requirements	6 months	6 months	Year of service & age 21
Excludable Employees	< 6 months	< 6 months	< Year of service & age 21

Determine the Testing Group

- Excludable terminated employees
 - Terminated plan participant
 - Credited with less than 501 hours of service
 - Doesn't receive allocation due to failure to satisfy the plan's minimum service and/or last day allocation requirements
- Special 401(k)/401(m) rules
 - 401(k) – terminated employee exclusion doesn't apply
 - Example: Ivy is a participant who terminates with 450 hours of service; she is **not** excludable from the 401(k) portion of the plan.
 - 401(m) – terminated employee exclusion applies only if arrangement contains a match with allocation conditions
 - Example: If the plan only allocates a match to active participants, Ivy **is** excludable from the 401(m) portion of the plan.

Determine the Testing Group

- Excluded ≠ excludable
 - Employees *excluded* from eligibility are not necessarily *excludable* from coverage testing
 - Example:
 - KLM Company has three divisions – K, L and M
 - KLM Company's 401(k) plan excludes Division L employees
 - The coverage testing group *includes* Division L employees who have satisfied the plan's age and service requirements

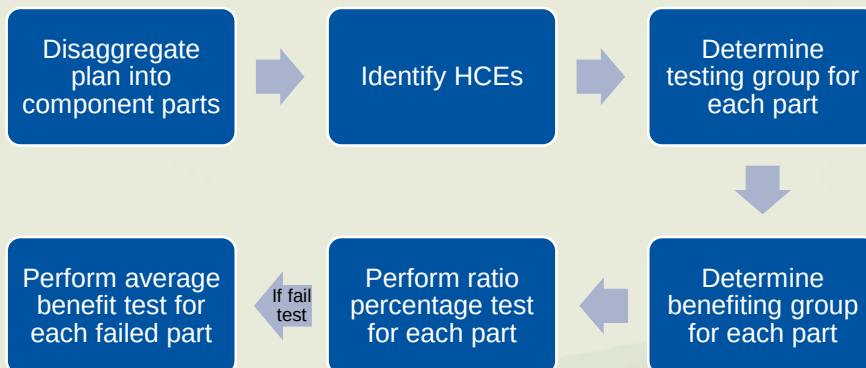
Determine the Benefiting Group

- 401(a) plan
 - Benefiting = receive an allocation of contributions or forfeitures
- 401(k) plan
 - Benefiting = eligible to defer, even if do not
- 401(m) plan
 - Benefiting =
 - Eligible to receive a match if had deferred, or
 - Eligible to make an after-tax employee contribution, even if do not
 - Impact of allocation conditions
 - **Example:** Nick is a 401(k) plan participant who terminated with 800 hours. The plan matches salary deferrals of participants employed on the last day of the plan year. Is Nick treated as benefiting? What if there are no allocation conditions to receive the match?

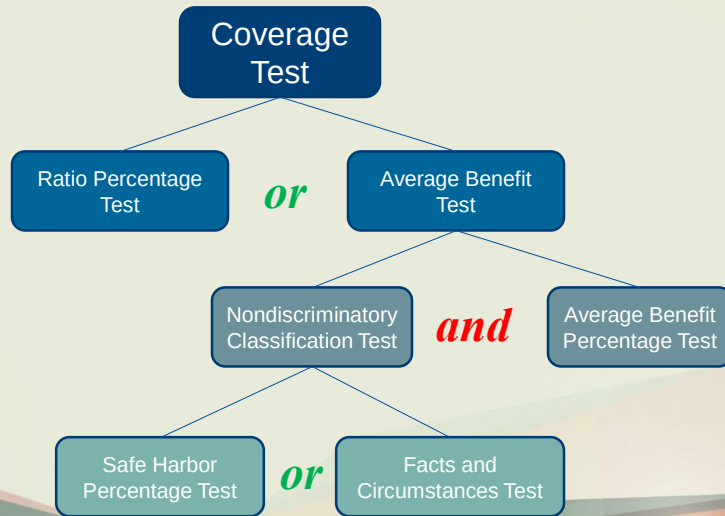
Testing Period

- The date coverage is determined will affect which employees are excludable and which are benefiting
- Annual testing
 - **Required** for 401(k) and 401(m) plans
 - Testing is generally on the last day of the plan year
 - Must take into account anyone employed during the year
 - To be excludable, must be excludable for the entire year
 - Benefiting with monthly/quarterly allocation requirements
- Quarterly testing – four testing dates, one in each quarter
- Daily testing – coverage must be met each day of the year

Perform the Coverage Test



Coverage Test Overview



Ratio Percentage Test

- Test compares the percentage of NHCEs who benefit with the percentage of HCEs that benefit
- Step 1 – Determine % of NHCEs benefiting

$$\frac{\text{NHCEs benefiting under the plan}}{\text{Total non-excludable NHCEs}}$$
- Step 2 – Determine % of HCEs benefiting

$$\frac{\text{HCEs benefiting under the plan}}{\text{Total non-excludable HCEs}}$$

Ratio Percentage Test

- Step 3 – Calculate the plan’s ratio percentage
 - Percentage of NHCEs benefiting under the plan must be *at least* 70% of the percentage of HCEs benefiting under the plan

$$\frac{\% \text{ of NHCEs benefiting}}{\% \text{ of HCEs benefiting}} \geq 70\%$$

Example – Ratio Percentage Test

- NOP Company has a 401(k) plan with 10 non-excludable employees
 - 2 HCEs – both are eligible to make elective deferrals and receive matching contributions
 - 8 NHCEs – only 6 of the 8 are eligible to participate (i.e., benefit) under the 401(k) plan

NHCEs		$\frac{6}{8} = 75\%$	$\frac{75\%}{100\%} = 75\%$ Ratio Percentage Passes
HCEs		$\frac{2}{2} = 100\%$	

Average Benefit Test

- Alternative minimum coverage test
- Complex, two-part test:
 - Nondiscriminatory classification test, *and*
 - Average benefit percentage test
- Both parts must be met

Nondiscriminatory Classification Test

Average Benefit Test – Part 1

The classification of employees who benefit must be reasonable *and* nondiscriminatory

Reasonable classification

- Based on objective business criteria
- Examples – nature of compensation (salaried, hourly), job categories (sales), geographic location (Florida)

Nondiscriminatory classification

- Cannot favor HCEs
- Demonstrated by satisfying either the
 - Safe harbor percentage test, *or*
 - Facts and circumstances test

Nondiscriminatory Classification

- Safe harbor percentage test
 - Step 1 – Determine the NHCE concentration percentage

$$\frac{\text{Non-excludable NHCEs}}{\text{Total non-excludable employees}}$$
 - Step 2 – Identify the safe and unsafe harbor percentages
 - Based on the NHCE concentration percentage
 - Table in Treasury Regulation 1.410(b)-4(c)(4)(iv)
 - Step 3 – Determine if safe harbor percentage test passes

$$\text{Plan's ratio \%} \geq \text{safe harbor \%}$$

Treas. Regulation 1.410(b)-4(c)(4)(iv)

NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	NHCE Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50.00	40.00	80	35.00	25.00
61	49.25	39.25	81	34.25	24.25
62	48.50	38.50	82	33.50	23.50
63	47.75	37.75	83	32.75	22.75
64	47.00	37.00	84	32.00	22.00
65	46.25	36.25	85	31.25	21.25
66	45.50	35.50	86	30.50	20.50
67	44.75	34.75	87	29.75	20.00
68	44.00	34.00	88	28.25	20.00
69	43.25	33.25	89	28.25	20.00
70	42.50	32.50	90	27.50	20.00
71	41.75	31.75	91	26.75	20.00
72	41.00	31.00	92	26.00	20.00
73	40.25	30.25	93	24.50	20.00
74	39.50	29.50	94	24.50	20.00
75	38.75	28.75	95	23.75	20.00
76	38.00	28.00	96	23.00	20.00
77	37.25	27.25	97	22.25	20.00
78	36.50	26.50	98	21.50	20.00
79	35.75	25.75	99	20.75	20.00

Example – Safe Harbor Percentage Test

QRS Company has 200 non-excludable employees

- 120 are NHCEs, 80 are HCEs
- The plan benefits 60 NHCEs and 72 HCEs
- The plan fails the ratio percentage test because the percentage of NHCEs benefiting under the plan is not at least 70% of the percentage of HCEs benefiting

Ratio Percentage Test

$$\begin{aligned}\frac{\% \text{ of NHCEs benefiting}}{\% \text{ of HCEs benefiting}} &= \frac{60/120}{72/80} = \frac{50\%}{90\%} = 55.56\%\end{aligned}$$

**Ratio Percentage
Fails**

Example – Safe Harbor Percentage Test

- QRS Company determines the NHCE concentration and then locates the safe harbor percentage from the table in the Treasury Regulations
- The plan passes the nondiscriminatory classification test (which is part 1 of the 2-part average benefit test) since the ratio percentage of 55.56% is more than the safe harbor percentage for a NHCE concentration of 60%

NHCE concentration

$$\frac{\# \text{ of NHCEs}}{\text{Total \# of Employees}} = \frac{120}{200} = 60\%$$

Ratio percentage = 55.56%

Safe Harbor and Unsafe Harbor Percentages Table

Non-Highly Compensated Employee Concentration	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50	40
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75

(Table from Treas. Regulation 1.410(b)-4)

Ratio percentage of 55.56% $\geq$ safe harbor 50% $\rightarrow$ test **passes**

Nondiscriminatory Classification

- Facts and circumstances test – Alternative test if plan fails the safe harbor percentage test
 - Step 1 – Determine the NHCE concentration percentage
 - Step 2 – Identify the unsafe harbor percentage
 - Step 3 – Satisfy the two-prong facts and circumstances test:

Plan's ratio % $\geq$ unsafe harbor %

and

Classification must be nondiscriminatory based on:

- Underlying business reasons
- Percentage of employees benefiting
- Percentage of employee benefiting under the plan in each salary range
- Difference between plan's ratio percentage and the employer's safe harbor percentage



Example – Facts and Circumstances Test

QRS Company has 200 non-excludable employees

- 120 are NHCEs, 80 are HCEs
- The plan benefits 50 NHCEs and 72 HCEs
- The plan fails the ratio percentage test because the percentage of NHCEs benefiting under the plan is not at least 70% of the percentage of HCEs benefiting

Ratio Percentage Test

$$\begin{aligned} \text{\% of NHCEs benefiting} &= \frac{50}{120} = 41.67\% \\ \text{\% of HCEs benefiting} &= \frac{72}{80} = 90\% \end{aligned}$$

Ratio Percentage

Fails



Example – Facts and Circumstances Test

- QRS Company determines the NHCE concentration and then locates the safe harbor percentage from the table in the Treasury Regulations
- The plan fails the safe harbor percentage test because the ratio percentage of 46.3% is below the safe harbor percentage for a NHCE concentration of 60%
- The plan may still pass the nondiscriminatory classification test using the facts and circumstances test since the plan's ratio percentage is above the unsafe harbor percentage

NHCE concentration

$$\frac{\text{\# of NHCEs}}{\text{Total \# of Employees}} = \frac{120}{200} = 60\%$$

Safe Harbor and Unsafe Harbor Percentages Table

Non-Highly Compensated Employee Concentration	Safe Harbor Percentage	Unsafe Harbor Percentage
0-60	50	40
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75

(Table from Treas. Regulation 1.410(b)-4)

$$\text{Ratio percentage} = 46.3\%$$

Ratio percentage of 46.3% ≥ unsafe harbor of 40%

Average Benefit Percentage Test

- Average Benefit Test – Part 2
- Examines the plan benefits received by participants
- Step 1 – Determine actual benefit % for each participant

$$\frac{\text{Total allocations}}{\text{IRC § 414(s) compensation}}$$

- All employer contributions and forfeitures are *included*
- Benefits from all plans sponsored by the employer are *included*
- Can be determined based on contributions or benefits
- Permitted disparity may be imputed in the calculation
- Can be calculated using current year figures or a two- or three-year average of benefit percentages

Average Benefit Percentage Test

- Step 2 – Average the actual benefit % for NHCEs
- Step 3 – Average the actual benefit % for HCEs
- Step 4 – Calculate the plan's average benefit percentage
 - The average benefit percentage of NHCEs must be **at least** 70% of the average benefit percentage of HCEs

$$\frac{\text{NHCE average benefit \%}}{\text{HCE average benefit \%}} \geq 70\%$$

Example – Average Benefit Percentage Test

Participant	Comp	Deferral %	Match %	Profit Sharing %	Actual Benefit %
Tara (HCE)	\$200,000	6%	3.0%	10%	19.0%
Vic (HCE)	\$175,000	5%	2.5%	10%	17.5%
HCE average benefit %					18.25%
Will (NHCE)	\$ 50,000	3%	1.5%	10%	14.5%
Yoni (NHCE)	\$ 25,000	3%	1.5%	10%	14.5%
Zac (NHCE)	\$ 10,000	0%	0%	10%	10.0%
NHCE average benefit %					13.0%

Average benefit percentage test

$$\frac{\text{NHCEs AB\%}}{\text{HCEs AB\%}} = \frac{13.00\%}{18.25\%} = 71.23\% \text{ average benefit percentage}$$

→ plan **passes** the average benefit percentage test

Coverage Failure

- Satisfying coverage is a condition of plan qualification
- If coverage is not met, the plan is **disqualified**
 - HCEs: Entire vested account is included in income
- Correction
 - Fail-safe provisions to bring in **just enough** NHCEs to pass
 - Retroactive plan amendment (Treas. Reg. § 1.401(a)(4)-11(g)(3)
 - Expand coverage or increase allocations
 - Must be adopted **within 9½ months** of plan year end
 - Must have **substance** for affected employee
 - Fix through EPCRS
 - Demographic error → VCP
 - Can't be self-corrected

Fail-Safe Coverage Provision

- Document language to automatically correct the failure by bringing in just enough participants to pass coverage
 - **Caution – may preclude use of average benefit test!**

FAIL-SAFE COVERAGE PROVISION. If the Plan fails the minimum coverage test under Code § 410(b) due to the application of an allocation condition, the Employer must amend the Plan in accordance with the provisions of Section 14.02(a) of the Plan to correct the coverage violation.

Alternatively, the Employer may elect under this AA to apply a Fail-Safe Coverage Provision that will allow the Plan to automatically correct the minimum coverage violation.

☐ The Fail-Safe Coverage Provision applies.

[Note: If the Fail-Safe Coverage Provision applies, the Plan may not perform the average benefit test to demonstrate compliance with the coverage requirements under Code § 410(b), except as provided in Section 14.02 of the Plan.]

Example – Fail-Safe Coverage Provision

- QRS Company plan

Ratio Percentage Test (*without fail-safe*)

$$\begin{array}{lcl} \text{\% of NHCEs benefiting} & = & \frac{50}{120} = 41.67\% = 46.3\% \\ \text{\% of HCEs benefiting} & = & \frac{72}{80} = 90\% \end{array}$$

- If the plan has a fail-safe coverage provision, the plan must automatically bring in just enough NHCEs who didn't benefit due to an hours of service/last day allocation requirement until the ratio percentage test passes

Ratio Percentage Test (*with fail-safe*)

$$\begin{array}{lcl} \text{\% of NHCEs benefiting} & = & \frac{76}{120} = 63.33\% = 70.4\% \\ \text{\% of HCEs benefiting} & = & \frac{72}{80} = 90\% \end{array}$$

2017 NAFE – Session #____ 401(k) Plan Testing 101

For more information, please contact:

Kimberly B. Martin, APA, CPC, QPA

Email – kmartin@nipa.org

Phone – (904) 556-2394