

Compliance Testing Basics

Retirement plans involve a lot of rules. One set of rules, involving nondiscrimination testing, is meant to ensure highly compensated employees (including company owners) don't unfairly receive more contributions into the retirement plan when compared to lower compensated employees. Even though some of these structures have been in place for several years, it is often a good idea to refresh on the rules and ensure the plan is operating in line with the plan document – particularly where large penalties can stack up over the years if left unchecked.

Here's What You Really Need to Know:

1. Retirement plans are required to run several types of “tests,” most of which are now outsourced to third parties. Under the Employee Retirement Income Security Act (ERISA), it is the plan sponsor's responsibility to monitor those who are hired to run these tests.
2. Plan sponsors should understand important definitions such as “highly compensated employees” and “key employees,” as plan sponsors generally are required to provide this information to service providers (e.g., recordkeepers and TPAs) so that compliance testing can be performed.
3. Plan sponsors should also know their elections in the plan document as it relates to compliance testing to ensure the testing performed aligns with the elections in the plan document.

Let's Dive In...

Compliance Testing Background

Although one of the advantages of a retirement plan is saving, one of the greatest benefits associated with a retirement plan is tax benefits. This concept applies to both employers in starting a retirement plan and employees who are contributing to the retirement plan.

Retirement plans are tax-favored vehicles. The Internal Revenue Service (IRS) governs this tax-favored treatment. One of the reasons that plan sponsors are concerned with (or should be concerned with) operating their plan in line with the plan document is so that the plan does not lose its tax-favored status. The IRS also governs rules regarding contributions, distributions, vesting, as well as nondiscrimination testing (NDT). These rules regarding NDT are in place to ensure that this tax-favored vehicle is offered across a broad cross-section of employees and not just to the highly compensated employees or owners of the company. As the rank-and-file employees save more for retirement, the rules from the IRS allow the highly compensated employees to defer more.

Compliance Testing Basics

To understand compliance testing, plan sponsors must start by understanding the difference between a highly compensated employee (HCE) and a non-highly compensated employee (NHCE). HCEs either own more than 5% of the company or have compensation exceeding a certain threshold set by the IRS which changes over time but is generally the top 20% of earners. But **use caution** as this definition is often confused with the definition of a key employee – another important definition for testing. A key employee is determined based on ownership status as well as officer status and also used for testing described further below.

There are three compliance tests that plan sponsors should be aware of:

1. Actual Deferral Percentage (ADP) Test: This test ensures that contributions made by HCEs do not disproportionately benefit them compared to the NHCEs. This tests the elective deferrals (both pre-tax and Roth deferrals, but not catch-up contributions) of the HCEs and NHCEs. Given that the testing is performed (in nearly all cases) by a TPA or recordkeeper, the actual calculation for testing will be saved for another article.

2. Actual Contribution Percentage (ACP) Test: Similar to the ADP test, the ACP test also ensures that employer matching contributions do not favor HCEs but is tested in a slightly different way (but again, likely not by the plan sponsor).

3. Top-Heavy Test: This test determines whether the plan is “top-heavy,” meaning it disproportionately benefits key employees. Plans with a majority of assets belonging to key employees must provide minimum benefits to non-key employees.

Plan sponsors should keep in mind that these are not the only tests, but some of the most common tests to know.

If a plan sponsor fails compliance testing, all is not lost. There are options, but correction of compliance testing failures should be prompt. For example, if the plan fails the ADP or ACP test, the plan must take the corrective action described in the plan document during the statutory correction period to cause the tests to pass. For excess contributions, the plan has 2 ½ months after the end of the testing plan year to correct. Generally, this information will come on a report from the recordkeeper or TPA so long as information has been provided timely to those service providers to run the tests.

You may have heard that not all plans have to run all the tests. One of the benefits of becoming a safe harbor plan design is that some tests such as the ACP and ADP test do not apply. This is because a specified contribution amount is required on behalf of the employer, which means that on its face, the plan will not be able to discriminate in favor of HCEs.

Compliance Testing Tips

So, if the plan sponsor doesn't perform these calculations on their own, why do plan sponsors need to know about these tests?

1. Plan sponsors are responsible for the selection and monitoring of service providers that will perform their compliance testing. In reviewing the service agreement with those service providers, plan sponsor should ensure that all required tests are covered and will be performed each year.

2. Plan sponsors are generally responsible for providing the data regarding key employees and HCEs. Plan sponsors should ensure that they properly categorize their participants.

3. The plan document is a critical component of compliance testing. For example, the information used for ACP and ADP testing can be based on “prior year” or “current year” contributions. The election made in the plan document should match the method used each year.

4. Like the plan document alignment, the plan sponsor will likely fill out a questionnaire when moving to a new recordkeeper or TPA and continually re-affirm that questionnaire each year. While the questionnaire may vary from service provider to service provider, it is important to ensure that it appropriately represents the plan document and data. This is the role of the plan sponsor who also must avoid compliance failures in the future, as the service provider will not take responsibility for errors in data.

5. Plan sponsors should also ensure that the payroll file aligns with the plan document and can be easily integrated (or exported) in a fashion necessary for reporting purposes annually for compliance testing purposes.

Action Items for Plan Sponsors

For plan sponsors, many plans likely just completed annual compliance testing for the year. Consider the following action items as you reflect and improve the fiduciary governance process for the coming year:

1. Review your plan document and ensure that the operation of the plan aligns with the terms of the plan document; if you are unsure, coordinate with your retirement plan advisor, consultant, or another knowledgeable ERISA professional.
2. Identify roles and responsibilities related to annual compliance testing and ensure the plan sponsor and all fiduciaries understand their respective duties. Review the agreements with service providers to ensure alignment and understanding.
3. In instances where the plan fails compliance testing, review plan design to ensure the plan has the optimal plan design in place.

Valorous Advisors | © 2024



Christopher D. Cervantes, C(k)P®, CFP®, CIMA®, NQPA®

Founder & Managing Partner
5700 Tennyson Parkway, Suite 250
Plano Texas 75024
214.800.4451

Christopher.Cervantes@valorousadvisors.com
www.valorousadvisors.com