

Understanding Compliance Testing for 401(k) Retirement Plans

401(k) plan requirements

A 401(k) plan must meet certain requirements to maintain its qualified tax status by passing nondiscrimination, top heavy, and coverage tests.

Nondiscrimination testing

A traditional 401(k) plan requires annual nondiscrimination testing—the Actual Deferral Percentage (ADP) test and the Actual Contribution Percentage (ACP) test.

An ADP test is calculated on both pre-tax 401(k) and Roth (if applicable) employee deferrals. The ACP test is calculated on employer matching contributions and non-deductible after-tax contributions. The tests compare highly compensated employees' (HCEs) deferral and match percentages to non-highly compensated employees' (NHCEs) deferral and match percentages.

Testing period for determining HCEs: Current year and prior year for owners. Prior year for employees earning more than the compensation limit.

To determine the HCE status for the current plan year, count anyone who owned more than 5 percent of the business at any point during the current or prior plan year, their family members, and any employee who earned more than the [HCE threshold](#) in the prior plan year.

ADP test example: Company A is owned 50/50 by 2 individuals and employs 3 other individuals who are not HCEs. All 5 individuals are eligible to participate in the 401(k) plan.

The owners are classified as HCEs and form 1 group. The 3 other individual employees form the NHCE group.

To perform the test:

1. Add up all deferral percentages for the NHCE group for the plan year (including zeros for NHCEs who are not participating).

NHCE 1 deferral	5%
NHCE 2 deferral	0%
NHCE 3 deferral	3%
Total NHCE deferral	8%

HCEs are defined as any of the following:

- More than 5 percent owners
- Family members of more than 5 percent owners (spouse, parents, children, or grandparents)
- Employees earning more than the [HCE threshold](#) in the prior plan year.¹

2. Divide the total NHCE deferral (8 percent) by the number of eligible NHCEs (3) to determine the ADP of NHCE (2.6 percent).

If the NHCE average is:

- **Between 0–2 percent:** Multiply that number by 2 to determine the maximum average for the HCEs
- **Between 2–8 percent:** Add 2 to that number to determine the maximum average for the HCEs
- **Greater than 8 percent:** Multiply that number by 1.25 to determine the maximum average for the HCEs

In this example, the test will add 2 to the ADP of 2.6 percent, resulting in the maximum average for HCEs of 4.6 percent. This number is the maximum average percentage that the 2 HCE members can defer into the plan for that year and pass the test.

If the average of the HCEs exceeds 4.6 percent, the ADP test will fail. To correct test failure, refunds plus allocable earnings may be issued to the HCEs of the plan. These refunds (except for designated Roth contribution refunds) will result in taxable income and must be distributed 2.5 months² after the plan year end (i.e., by March 15 for a calendar year plan) to avoid a 10 percent excise on the employer.

Note: The ACP test calculates the same way; however, it uses employer matching contributions instead of employee deferral contributions.

Top heavy testing

In addition to the ADP/ACP test, 401(k) plans are also subject to the performance of an annual top heavy test.

A retirement plan is considered top heavy when key employees hold more than 60 percent of the retirement plan assets as of the determination date.

The determination date is defined as the last day of the previous plan year or the last day of the plan year for a first year plan. If a plan is top heavy, a maximum 3 percent employer contribution may be required for all eligible non-key employees for the current plan year.

Key employees are defined as any of the following:

- Officers earning more than the [Key Employee](#) threshold annually.¹
- 5 percent owners (anyone who owns more than 5 percent of the company)
- More than 1 percent owners earning more than \$150,000

Note: Key employee determination applies the owner's interest to their spouse, children, parents and grandparents therefore treating them as owners of that same interest.

To determine if a calendar year plan is top heavy, check to see if the key employees held more than 60 percent of the retirement plan assets as of the last date of the plan year, December 31 (the determination date).

Testing period for determining key employees: A key employee is any employee who meets the definition of key employee in the prior year.

Key employee determination example (calendar year plan): In testing, if a plan is top heavy in the prior year, count a key employee as any employee who meets the definition of key employee in the preceding year.

For example, if more than 60 percent of the plan's assets of the last date of the plan year belong to key employees, the plan is considered top heavy for the following plan year and a 3 percent maximum employer contribution may be due to all eligible non-key employees. This contribution is subject to a required vesting schedule. Typically, this will be the same vesting schedule used for discretionary employer contributions.

If the plan is top heavy for the first plan year, the plan will be considered top heavy for both the first plan year as well as the second plan year. For example, if the plan is established in 2022 and the plan is top heavy as of December 31, 2022, it will be top heavy for both 2022 and 2023.

Coverage testing

Coverage testing requires that an appropriate percentage of NHCEs are benefiting under the plan. The regulations state that a plan must satisfy the ratio percentage test in which the plan must benefit at least 70 percent of the NHCEs (the 70 percent test, also known as the "ratio percentage test").

If the plan does not satisfy this test, it may need a document fail-safe. Some plan documents do not contain a fail-safe and would require an amendment (sometimes called an 11(g) amendment) to increase participation to resolve the failure. The amendment would need to be made by the 15th day of the 10th month after the end of the plan year. One or more additional participants (as defined in the plan document) will be added into the test and receive an employer contribution until enough participants are benefiting under the plan for the test to pass.

Safe harbor 401(k) plans

A safe harbor plan is a qualified plan in which the ADP/ACP nondiscrimination test and top heavy test are deemed to pass and are satisfied. The employer may satisfy these requirements if they make a mandatory contribution of either a 3 percent nonelective contribution to all eligible employees, whether they contribute or not, or a matching contribution of 100 percent of the first 3 percent of deferrals and 50 percent on the next 2 percent of deferrals. Other matching formulas that are allowed are 100 percent of deferrals up to 4, 5, or 6 percent with every payroll. All safe harbor employer contributions are 100 percent vested.

Note: A safe harbor provision can be added to a traditional 401(k) plan; however, the Internal Revenue Service (IRS) has strict rules regarding the implementation of a safe harbor plan once a 401(k) plan is in place. Safe harbor plans must satisfy coverage requirements and the top heavy exemption could be impacted by additional contributions and forfeiture allocations.

¹ Applicable laws and regulations regarding Cost of Living Adjustments (COLA) are complex and subject to change each year. For legal or tax advice concerning your situation, consult your financial advisor.

² Under certain EACA/QACA conditions, the plan has 6 months following plan year end.