Compliance Tests – What Are They and How Do I Interpret the Results?

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# Agenda

Prerequisites

Highly Compensated Employees (HCEs)

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- Key Employees
- 410b Coverage Test
- ADP/ACP Test
- General Test
- Top Heavy Test



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## Prerequisites

Know the regulations!

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- Cheetah (online research platform)
  - URL: <u>http://www.wkcheetah.com/</u>
- Technical Answer Group (TAG)
  - Contact <u>support@ftwilliam.com</u> for your free 2 week trial of TAG
  - Subject line: Compliance Webinar Two week trial to TAG request
- Review plan document
- Review ownership to determine related employers.
  - Determine if aggregation is required
- Verify that the census data is reasonable
- Review eligibility to make sure it is correct



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# Highly Compensated Employees (HCEs)

- HCE satisfies one of the qualifications below.
  - Ownership Owns more than 5% of the employer or a related employer, in either the current or prior plan year, or
  - Compensation Compensation from the prior plan year is greater than the indexed dollar amount for that plan year (\$120,000.00 in 2016).
- Be sure to check the plan document to determine if top paid group has been elected.



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# Key Employees

- Key satisfies one of the qualifications below.
  - Ownership

- Owns more than 5% of the employer or a related employer, during the determination period, or
- Owns more than 1% of the employer or a related employer, during the determination period, and earns more than \$150,000.00 (not indexed).
- Officer status
  - Is an officer and earns more than the indexed dollar amount (\$170,000.00 in 2016).



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# 410(b) Coverage Test Overview

- 410(b) Coverage Test Ensures the plan benefits a non-discriminatory percentage of Non-Highly Compensated Employees.
- How does a plan satisfy the 410(b) coverage rules?
  - Must pass either the ratio percentage test OR the average benefits test
    - The ratio percentage test passes if a nondiscriminatory percentage of NHCEs are benefitting as compared to the percentage of HCEs that are benefitting, for each source.
    - If the ratio percentage test fails, the plan may have the option to use the average benefits test (check plan document).
    - The average benefits test tests the amount of benefit rather than the number of persons benefitting. There are two parts of the average benefits test, BOTH must pass.
      - The nondiscriminatory classification test
      - The average benefit percentage test



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# 410(b) Ratio Percentage Test Steps

- 1. Determine Non-Excludable employees
- 2. Determine Benefitting employees
- 3. Divide Benefitting NHCEs by Non-Excludable NHCEs
- 4. Divide Benefitting HCEs by Non-Excludable HCEs
- 5. Divide NHCE ratio (3) by HCE ratio (4) = Ratio Percentage
- 6. If Ratio Percentage  $\geq$  to 70%, PASS, else FAIL



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## Excludable Employees for 410(b)

- Who are excluded from the coverage tests?
  - Persons who have not met eligibility due to age or service requirements are excluded from the Coverage Test.
  - Persons who are union or nonresident aliens.
  - Persons who terminated, worked 500 hours or less and did not benefit due to termination.
- Potential issues for the ratio percentage test:
  - Plans with a last day rule, 1000 hours requirement or exclusions due to class would be potentially problematic as they are not included in the "benefitting" count, but are included in the "non-excludable" count.

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# Benefitting Employees for 410(b)

### Deferrals

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- If a nonexcludable employee is eligible to defer, they are considered benefitting employees for purposes of the elective deferral portion of the 410(b) test, even if they did not actually make any deferrals.
- Match
  - If a nonexcludable employee is eligible to defer and eligible to receive a match allocation, that employee is a benefitting employee as applicable to the match portion of the 410(b) test, even if they did not make any deferral contributions.
- Nonelective
  - If a nonexcludable employee receives a nonelective contribution, then that employee is considered to be benefitting for the nonelective section.



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### Ratio Percentage Test (Example 1)

- 1. Determine Non-Excludable employees
  - Non-excludable NHCEs = 10 and non-excludable HCEs = 3
- 2. Determine Benefitting employees

- Benefitting NHCEs = 8 and benefitting HCEs = 3
- 3. Divide Benefitting NHCEs by Non-Excludable NHCEs
  - 8/10 = 80% for the NHCE ratio
- 4. Divide Benefitting HCEs by Non-Excludable HCEs
  - 3/3 = 100% for the HCE ratio
- 5. Divide NHCE ratio (step 3) by HCE ratio (step 4) = Ratio Percentage
  - 80%/100% = 80% for the ratio percentage
- 6. If Ratio Percentage  $\geq$  to 70%, PASS, else FAIL
  - 80% is more than 70%  $\rightarrow$  **PASS**.



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## Ratio Percentage Test – Demo

Let's take a look at the ftwilliam.com Compliance Module

• Scenario

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- Eligibility and HCE determination has been verified.
- Plan has employed on last day of plan year and 1000 hours requirements for the employer non-elective contribution.
- The plan passes with fact pattern in example 1 from slide 10.



# Ratio Percentage Test

(Example 2)

- 1. Determine Non-Excludable employees
  - Non-excludable NHCEs = 10 and non-excludable HCEs = 3
- 2. Determine Benefitting employees

- Benefitting NHCEs = 4 and benefitting HCEs = 3
- 3. Divide Benefitting NHCEs by Non-Excludable NHCEs
  - 4/10 = 40% for the NHCE ratio
- 4. Divide Benefitting HCEs by Non-Excludable HCEs
  - 3/3 = 100% for the HCE ratio
- 5. Divide NHCE ratio (step 3) by HCE ratio (step 4) = Ratio Percentage
  - 40%/100% = 40% for the ratio percentage
- 6. If Ratio Percentage  $\geq$  to 70%, PASS, else FAIL
  - 40% is less than 70%  $\rightarrow$  FAIL.
  - \* changes from example 1 are in red



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### FAILED the Ratio Percentage Test?!? Down the rabbit hole we go.





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## 410(b) Average Benefit Test

- 410(b) Average Benefit Test (Two part test, <u>both</u> must pass)
  - Reasonable Classification Test (also a two part test; <u>both</u> must pass)
    - Reasonable classification requirement, and
    - Nondiscriminatory classification test (two part test, <u>only one</u> must pass)
      - The safe harbor percentage test; or
      - The facts-and-circumstances test (two part test, <u>both</u> must pass)
        - The unsafe harbor percentage test, and
        - The facts-and-circumstances test
  - Average Benefit Percentage Test



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### Reasonable Classification Test (Part 1): Reasonable Classification Requirement

- This looks at whether the classification of employees that are eligible to participate in the plan is:
  - Reasonable

- Identified in the plan document
- Clear and objective criteria
- Permissible Classification Examples
  - Job categories (interns, janitors, teachers, etc.)
  - Type of compensation (hourly or salary)
  - Location
- Not Permissible Classification Examples
  - Employee Names
  - Hair color, skin color, eye color, etc.



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### Reasonable Classification Test (Part 2): Nondiscriminatory Classification Test

- Nondiscriminatory classification test (two part test, only one must pass)
  - The safe harbor percentage test; <u>or</u>
  - The facts-and-circumstances test.



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### Nondiscriminatory Classification Test – Safe Harbor Percentage Test

- 1. Determine the NHCE Concentration Percentage
- 2. Determine Safe Harbor and Unsafe Harbor Percentages
- 3. Compare the Ratio Percentage to the Safe Harbor Percentage
  - If the ratio percentage test results are greater than or equal to the safe harbor percentage, then the nondiscriminatory classification test is satisfied, and we can move on to the average benefit percentage test.
  - If the ratio percentage test results are less than the safe harbor percentage, then the Safe Harbor Percentage Test fails.



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### Safe Harbor Percentage Test Example

#### 1. Determine the NHCE Concentration Percentage

- NHCE concentration percentage = # of NHCEs / # of nonexcludable employees
- # of NHCEs = 7

- # of non-excludable employees = 10
- NHCE concentration % = 7/10 = 70%
- 2. Determine Safe Harbor and Unsafe Harbor Percentages
  - Safe Harbor % = 42.50%
  - Unsafe Harbor % = 32.50%
- 3. Compare the Ratio Percentage to the Safe Harbor Percentage
  - Using a Ratio Percentage of 40%
  - 40% is less than 42.50%, so this test FAILS.



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### Safe Harbor & Unsafe Harbor Percentages

- NHCE concentration percentage = # of NHCEs / # of nonexcludable employees
- Use table to determine Safe Harbor and Unsafe Harbor Percentage

able 6-2. Applicable Safe Harbor and Unsafe Harbor Percentages				
NHCE Concentration <u>Percentage</u>	Safe Harbor <u>Percentage</u>	Unsafe Harbor <u>Percentage</u>		
0-60	50.00	40.00		
61	49.25	39.25		
62	48.50	38.50		
63	47.75	37.75		
64	47.00	37.00		
65	46.25	36.25		
66	45.50	35.50		
67	44.75	34.75		
68	44.00	34.00		
69	43.25	33.25		
70	42.50	32.50		



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# 410(b) Average Benefit Test - Review

- 410(b) Average Benefit Test (Two part test, <u>both</u> must pass)
  - Reasonable Classification Test (also a two part test; <u>both</u> must pass)
    - Reasonable classification requirement, and
    - Nondiscriminatory classification test (two part test, <u>only one</u> must pass)
      - The safe harbor percentage test; or
      - The facts-and-circumstances test (two part test, <u>both</u> must pass)
        - The unsafe harbor percentage test, and
        - The facts-and-circumstances test
  - Average Benefit Percentage Test



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### Nondiscriminatory Classification Test – The Facts-and-Circumstances Test

- Two-part test, both parts must pass.
  - . The plan's ratio percentage must be greater than or equal to the unsafe harbor percentage.
    - Ratio Percentage = 40%, Unsafe Harbor = 32.50%, 40%>= 32.50%, so PASS!
  - 2. The plan must also satisfy the facts-and-circumstances test, which looks at the coverage classifications to determine if they are nondiscriminatory.
    - Note that the IRS ultimately makes that determination; there is no set standard. As such you can apply to the IRS for determination on whether or not the coverage classifications are non-discriminatory.
    - Some relevant factors that the IRS takes into account include:
      - Business reason for the classification
      - Ratio percentage (the higher, the better)
      - Salary range of benefitting employees as compared to the employee's
      - Average benefit percentage test results



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## Average Benefit Percentage Test Steps

- 1. Determine total benefits for each nonexcludable employee
- 2. Determine each nonexcludable employee's benefit percentage
  - Divide total benefits / compensation for each nonexcludable employee
- 3. Determine NHCE average benefit percentage
- 4. Determine HCE average benefit percentage
- 5. Divide NHCE average benefit percentage by HCE average benefit percentage
- 6. If average benefit percentage is greater than or equal to 70%, Pass!



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### Average Benefit Percentage Test Example

#### 1. Determine total benefits

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- NHCE1: 10,000 HCE1: 50,000
- NHCE2: 2,000 HCE2: 25,000
- 2. Determine each nonexcludable employee's benefit percentage
  - NHCE1 = 10,000/60,000 = 16.67% HCE1 = 50,000/265,000 = 18.87%
  - NHCE2 = 2,000/15,000 = 13.33% HCE2 = 25,000/195,000 = 12.82%
- 3. Determine NHCE average benefit percentage
  - (16.67% + 13.33%) / 2 = 15%
- 4. Determine HCE average benefit percentage
  - (18.87% + 12.82%) / 2 = 15.84%
- 5. Divide NHCE average benefit percentage by HCE average benefit percentage
  - 15%/15.84% = 94.67%
- 6. If average benefit percentage is greater than or equal to 70%, Pass!
  - Since  $94.67\% \ge 70\% \rightarrow PASS!$



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Compensations NHCE1: 60,000 HCE1: 265,000 NHCE2: 15,000 HCE2: 195,000

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# 410(b) Average Benefit Test - Demo

- Let's take a look at the ftwilliam.com Compliance Module
  - Scenario

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- Eligibility and HCE determination has been verified
- Plan has employed on last day of plan year and 1000 hours requirements for the Employer non elective contribution
- The plan Fails with fact pattern in example 2
- The system performs the 410(b) Average Benefit Test



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### ADP/ACP Test

- The actual deferral percentage (ADP) test is the nondiscrimination test for elective deferrals, including 401(k) and Roth contributions.
- The actual contribution percentage (ACP) test is the nondiscrimination test for match and after-tax contributions.
- ADP/ACP Test not required for certain plans, including:
  - SIMPLE 401(k) plans
  - Safe harbor 401(k) plans that satisfy all safe harbor requirements
  - Certain governmental plans



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### ADP Test Calculation Steps

- 1. Determine actual deferral ratios (ADR's) for each participant by dividing elective deferrals by compensation.
- 2. Average the NHCE ADR's to obtain the NHCE actual deferral percentage (ADP).
- 3. Average the HCE ADR's to obtain the HCE ADP.
- 4. Using the NHCE ADP, calculate the maximum HCE ADP.
- 5. Compare the maximum ADP to the HCE's ADP. If the HCE's ADP is greater than the maximum ADP, fail, else pass.

If the NHCE ADP is:	Test to use:
< = 2%	Multiply the NHCE ADP by 2
2 < 8	Add 2% to the NHCE ADP
>= 8%	Multiply the NHCE ADP by 1.25



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### ACP Test Calculation Steps

- 1. Determine actual contribution ratios (ACR's) for each participant by dividing match plus after-tax contributions by compensation.
- 2. Average the NHCE ACR's to obtain the NHCE actual contribution percentage (ACP).
- 3. Average the HCE ACR's to obtain the HCE ACP.
- 4. Using the NHCE ACR's, calculate the maximum HCE ACP.
- 5. Compare the maximum ACP to the HCE's ADP. If the HCE's ACP is greater than the maximum ACP, fail, else pass.

If the NHCE ACP is:	Test to use:
$< = 2^{0/0}$	Multiply the NHCE ACP by 2
2 < 8	Add 2% to the NHCE ACP
>= 8%	Multiply the NHCE ACP by 1.25



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ACP Test

### (Example 3)

Testing Data (no after-tax contributions)

• Match Contributions

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- NHCE1: 2,000 HCE1: 10,600
- NHCE2: 0.00 HCE2: 7,000
- 1. Determine ACR's for each non-excludable employee.
  - NHCE1: 2,000/60,000 = 3.33% HCE1: 10,600/265,000 = 4.00%
  - NHCE2: 0 / 15,000 = 0.00% HCE2: 7,000/195,000 = 3.59%
- 2. Average the NHCE ACR's to obtain the NHCE (ACP).
  - (3.33% + 0.00%)/2 = 1.67%
- 3. Average the HCE ACR's to obtain the HCE ACP.
  - (4.00% + 3.59%)/2 = 3.80%
- 4. Using the NHCE ACR's, calculate the maximum HCE ACP.
  - NHCE ACP = 1.67%, since < 2%, 1.67% \* 2 = Maximum ACP of 3.33%
- 5. Compare the maximum ACP to the HCE's ACP.
  - 3.80%>3.33%, Fail



# Compensations NHCE1: 60,000 HCE1: 265,000 NHCE2: 15,000 HCE2: 195,000

If the NHCE ACP is:	Test to use:
$< = 2^{0}/_{0}$	Multiply the NHCE ACP by 2
2 < 8	Add 2% to the NHCE ACP
>= 8%	Multiply the NHCE ACP by 1.25

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### ADP/ACP Test – Demo

- Let's take a look at the ftwilliam.com Compliance Module
  - Scenario

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- Eligibility and HCE determination has been verified.
- The plan fails the ADP test.
- The plan fails the ACP test with fact pattern in example 3.
- The system estimates QNECS and computes refunds.





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### General Test

- The general test is the non-discrimination test for non-elective contributions.
- Must pass the rate group test with a ratio percentage of 70% or greater, or pass the rate group test with a ratio percentage equal to or greater than the midpoint, and must pass the average benefit percentage test.
- Can test on either benefits basis or contributions basis.
- Benefits basis uses EBARs, contributions basis uses allocation rates.
- Certain types of non-elective contribution formulas automatically satisfy the nondiscrimination requirements for non-elective contributions and do not need to pass the general test. In general, these include:
  - Pro-rata allocation formula
  - Integrated allocation formula
  - Age-weighted allocation formula



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## General Test Steps

- Step 1: Determine Rate Groups \*
  - Calculate each participant's allocation rate.
  - Sort the list of participants by allocation rate, from high to low.
  - Rate groups are determined by HCEs. Each rate group includes all employees that have an allocation rate that is greater than or equal to the HCE's rate.
- Step 2: Test that each rate group satisfies the Ratio Percentage Test (At 70% or greater)

Or, if any rate group is less than 70%,

Step 3 (if fail step 2): Test that each rate group satisfies the nondiscriminatory classification test AND that the Average Benefit Percentage Test passes

\* This slide and the following example assumes we are testing on allocation basis not benefits basis (EBARs)



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### General Test – Rate Group Test Example

#### Step 1: Determine Rate Groups

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- Calculate each participant's allocation rate.
- Sort the list of participants by allocation rate, from high to low.
- Rate groups are determined by HCEs. Each rate group includes all employees that have an allocation rate that is greater than or equal to the HCE's rate.
- Step 2: Test that each rate group satisfies the Ratio Percentage Test (At 70% or greater).
- Step 3: If any rate group has a ratio percentage that is less than 70%, then we need to pass the Average Benefit Test.

	Non-elective		Allocation Rate		NHCE	HCE Ratio		
Name	Allocations	Compensation	(Alloc/Comp)	Rate Group	Ratio %	%	Ratio Percentage	Pass/Fail
NHCE1	\$ 3,000.00	\$ 60,000.00	5.00%					
HCE1	\$ 13,250.00	\$ 265,000.00	5.00%	Group 1	1/2 = 50%	1/2 = 50%	50%/50% = 100%	Pass at 70%
HCE2	\$ 5,850.00	\$ 195,000.00	3.00%	Group 2	1/2 = 50%	2/2 = 100%	50%/100% = 50%	Pass at Midpoint
NHCE2	\$ 300.00	\$ 15,000.00	2.00%					



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### NHCE Concentration Percentage & Midpoint

- NHCE concentration percentage = 2 NHCEs / 4 nonexcludable ees = 50%
- Use table to determine midpoint, between the Safe Harbor and Unsafe Harbor Percentage. (50%+40%)/2 = 45%

Table 6-2. Applicable Safe Harbor and Unsafe Harbor Percentages					
NHCE Concentration <u>Percentage</u>	Safe Harbor <u>Percentage</u>	Unsafe Harbor <u>Percentage</u>			
0–60	50.00	40.00			
61	49.25	39.25			
62	48.50	38.50			
63	47.75	37.75			
64	47.00	37.00			
65	46.25	36.25			



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## Average Benefit Percentage Test Steps

- 1. Determine total benefits for each nonexcludable employee
- 2. Determine each nonexcludable employee's benefit percentage
  - Divide total benefits / compensation for each nonexcludable employee
- 3. Determine NHCE average benefit percentage
- 4. Determine HCE average benefit percentage
- 5. Divide NHCE average benefit percentage by HCE average benefit percentage
- 6. If average benefit percentage is greater than or equal to 70%, Pass!



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### General Test - Demo

Let's take a look at the ftwilliam.com Compliance Module

• Scenario

- Eligibility and HCE determination has been verified
- Non-Elective formula is New Comparability
- Testing on the benefits basis using ftw EARs (EBARs)
- The plan fails the Gateway test
- The plan fails the Rate Group test at the Midpoint
- The plan passes the Average Benefit test
- The system computes suggestions for passing the Gateway & the Rate Group test



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# Top Heavy Test

- Top Heavy Test Looks at balances for all key and non-key employees, as of the determination date to verify that balances are not discriminatory.
- The determination date is the last day of the prior plan year.
  - Exception: if it is the first plan year, the determination date is the last day of the first plan year.
- Account balances that are excluded from the test:
  - Former key employees
  - Participants that terminate prior to the determination year
  - Unrelated rollover account balances



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# Top Heavy Ratio Steps

#### 1. Add together all key balances as of the determination date

• This includes all DC and DB plans that are required to be aggregated together. So if a DC plan and a DB plan were being tested, this would include the DC account balance and the present value of accrued benefits as of the determination date.

#### 2. Add all key distributions

- Distributions due to termination, death or disability that made within 12 months prior to the determination date.
- In-service distributions made within five years of the determination date.
- 3. Add together all key and non-key balances as of the determination date
- 4. Add all key and non-key distributions (same rules as step 2)
- 5. Top Heavy Ratio = Key balances (Step 1) + Key distributions (Step 2)

Key + non-key balances & distributions (Step 3 + Step 4)



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### Top Heavy Test (Example 4)

	Determination Date	Distributions	Inservice Dist	
	Balance	(within 12 mo)	(within 5 years)	Total
Key	\$ 500,000.00	\$ 50,000.00	\$ 15,000.00	\$ 565,000.00
Non-key	\$ 100,000.00	\$ -	\$ 10,000.00	\$ 110,000.00
	\$ 600,000.00	\$ 50,000.00	\$ 25,000.00	\$ 675,000.00

- 1. Add together all key balances as of the determination date
  - 500,000.00

- 2. Add all key distributions
  - 65,000.00
- 3. Add together all key and non-key balances as of the determination date
  - 600,000.00
- 4. Add all key and non-key distributions (same rules as step 2)
  - 75,000.00
- 5. Top Heavy Ratio = Key balances/(key + non-key balances)
  - Top Heavy Ratio = (500,000 + 65,000.00)/(600,000 + 75,000.00) = 83.70%
  - This plan is top heavy since 83.70% is greater than 60%.

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## Top Heavy Test – Demo

Let's take a look at the ftwilliam.com Compliance Module

• Scenario

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- Eligibility and Key determination has been verified
- Transactions have been created and posted
- Plan is top Heavy based on with fact pattern in example 4



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## Thank you for attending!

- CE certificates will be sent out within 3-4 weeks via e-mail.
- Recording will be made available on website.
- Please click <u>here</u> for more upcoming webinars!
- E-mail us at <u>support@ftwilliam.com</u> for a demo of the Compliance software!



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