Benefit Insights

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A non-technical review of qualified retirement plan legislative and administrative issues **December 2014**

Year-End Compliance Testing Overview

The end of the calendar year is fast approaching which means the plan year end for many qualified plans. It will be time for plan sponsors to collect complete employee data to enable their service providers to perform the numerous compliance tests required to retain the plans tax qualified status.

This article provides a brief description of the required defined contribution plan compliance tests as well as an overview of the census data collection process.

Employee Census Data Collection

At the end of the plan year the employer must prepare a census report. This information is used to determine eligibility, calculate and allocate contributions, perform compliance testing, update participant vesting and to prepare Form 5500 for filing with the Department of Labor. Accurate census information is critical to performing these administrative functions. In general, the census consists of the names, compensation, relevant dates (hire, birth, termination, rehire) and the number of hours worked for all employees who were employed during any portion of the year—not just those actively participating in the plan.

Compensation typically includes gross compensation reported on Form W-2 unless the plan specifically excludes certain types of compensation for plan purposes. When determining contributions and performing the 2014 tests, plan sponsors may only take into account each participant's compensation up to $260,000.

Owners and Officers

It is important to identify the owners and officers of the company as this information is used to determine "highly compensated employees" for purposes of the nondiscrimination tests and "key employees" for the top heavy test.

It is also important to identify which employees are relatives of any owners since they may be considered owners through stock attribution rules. An employee is deemed to own the stock or interest owned by his or her spouse, parents, children and grandchildren. For example, if Harry works for a corporation owned by his father, he will also be considered to own the corporation for testing purposes because of the stock attribution rules.

Highly Compensated Employees (HCEs)

HCEs are generally those employees who:

- Were a more than 5% owner of the employer at any time during the current or preceding plan year, or
- Had compensation from the employer in the preceding plan year in excess of an indexed limit. For example if an employee earned more than $115,000 in 2013, the employee is considered an HCE in 2014. The plan may limit the number of employees in this category to the top 20% when ranked by compensation.

All other employees are considered non-highly compensated employees (NHCEs).

Key Employees

A key employee is an employee who meets any of the following criteria during the determination year (usually the preceding plan year):

- Owns more than 5% of the employer;
- Owns more than 1% of the employer and had compensation in excess of $150,000; or
- Is an officer of the employer with compensation in excess of an indexed limit ($170,000 for 2014), with certain limits on the maximum number in this category.

Related Businesses

If an owner of a company has ownership in another company, it must be determined if the companies are "related" as a controlled group. Companies could also be related as an "affiliated service" group even if there is no common ownership.

Related companies are treated as one company for certain plan purposes including nondiscrimination testing. Therefore, it is important that relationships with other businesses be shared with the service provider performing required plan testing.

Required Plan Testing

The IRS has established a multitude of requirements a qualified plan must meet in order to be considered qualified. In general, the requirements assure that contributions are allocated fairly to each eligible participant. Below is a brief description of the required tests.

Minimum Coverage Test

Qualified retirement plans are required to benefit a nondiscriminatory group of employees who have satisfied the eligibility requirements of the plan. Under the ratio percentage test, the percentage of NHCEs benefiting under the plan must be at least 70% of the percentage of HCEs who benefit under the plan. If the plan does not pass this test, it may still be able to pass a more complex average benefits test.

Average Deferral Percentage (ADP) and Average Contribution Percentage (ACP) Tests

The ADP test is performed on employee deferrals (including Roth contributions) while the ACP test is performed on matching and/or voluntary after-tax contributions. The percentages for each employee within the HCE and NHCE groups are totaled and averaged to get the ADP and ACP for each group. The averages for the HCE group may not exceed a specific ratio of the average for the NHCE group as follows:

- NHCE group average less than 2%: maximum HCE average is 2 times the NHCE average;
- NHCE group average between 2%–8%: maximum HCE average is the NHCE average +2%;
- NHCE group average over 8%: maximum HCE average is the NHCE average times 1.25.

In performing the ADP test, all active and terminated employees eligible to defer at any time during the plan year are included, whether or not they actually made a deferral. In general, the following employees are included in the ACP test:

- All active and terminated employees who met the plan's requirements to receive a match regardless of whether they actually made a deferral and received a match; and
- All employees eligible to make a voluntary after-tax contribution at any time during the year.

Plans that do not pass the test(s) must take some action, such as corrective distributions or additional employer contributions. Corrective distributions generally must be made within 2½ months after the end of the plan year to avoid a 10% excise tax.

Safe harbor 401(k) plans are deemed to automatically satisfy the ADP and ACP testing requirements. This allows HCEs to defer up to the annual dollar limit ($17,500 for 2014) regardless of how much or how little the NHCEs defer. As a trade-off, safe harbor plans must meet a number of requirements including minimum employer contributions, immediate vesting and participant notices.

Top Heavy Test

A plan is top heavy if the account balances of key employees on the determination date (usually the last day of the preceding plan year) are more than 60% of the total account balances of all participants. For example, the top heavy test performed using the December 31, 2014 account balances will determine if the plan is top heavy in 2015. Generally, all plans maintained by the employer, including defined benefit plans, are aggregated for purposes of this test. Certain safe harbor plans are exempt from the top heavy rules.

If the plan is considered to be top heavy, participants must become fully vested in at least six years. In addition, for each year the plan is top heavy, minimum contributions must be made on behalf of non-key participants still employed on the last day of the plan year in an amount equal to the highest contribution rate allocated to any key employee, up to a maximum of 3% of compensation. For example, if a top heavy profit sharing plan has one key employee who received a contribution of 2% of his or her compensation, then all non-key employees would be entitled to a 2% contribution. If the key employee receives a 4% contribution, then the non-key employees must receive at least a 3% contribution.

The top heavy regulations provide that salary deferrals made by key employees are considered employer contributions but deferrals by non-key employees are considered employee contributions. In other words, deferrals by a key employee can trigger the top heavy contribution requirement, yet deferrals by a non-key employee cannot be used to satisfy the requirement.

For example, if the plan is top heavy and one key employee defers 4%, the 3% minimum contribution requirement will apply to all non-key employees who have met the plan's eligibility requirements, even those who have elected not to make deferrals.

Profit sharing and matching contributions as well as forfeitures are considered employer contributions for purposes of determining if the minimum is met. If the employer sponsors multiple plans, only one plan has to provide the minimum.

Annual Additions Test

Annual additions allocated to a participant's account during the plan's limitation year (usually the plan year) are limited to the lesser of 100% of compensation or an indexed maximum limit ($52,000 in 2014). All defined contribution plans of the employer are aggregated in determining whether the limit has been exceeded. Annual additions include:

- Employer contributions, e.g. profit sharing, matching;
- Employee 401(k) elective deferrals, including

Roth contributions;

- Employee after-tax voluntary and mandatory contributions; and
- Forfeiture allocations.

Rollovers, earnings, loan repayments and 401(k) catch-up contributions are not considered annual additions.

Several methods are permissible for correcting a failed annual additions test and the plan document will specify the applicable method. The most common method for correcting a 401(k) plan failure is to first return voluntary after-tax and 401(k) deferrals in the amount necessary to pass the test.

Conclusion

The end of the year is the time to prepare for annual testing and reporting. Complete employee data must be collected in order to accurately perform the required year-end administrative functions and testing to keep the plan in compliance.

IRS and Social Security Annual Limits

Each year the U.S. government adjusts the limits for qualified plans and Social Security to reflect cost of living adjustments and changes in the law. Many of these limits are based on the "plan year." The elective deferral and catch-up limits are always based on the calendar year. Here are the 2015 limits as well as the 2014 limits for comparative purposes:

Limit	2015	2014
Maximum compensation limit	$265,000	$260,000
Defined contribution plan maximum contribution	$53,000	$52,000
Defined benefit plan maximum benefit	$210,000	$210,000
401(k), 403(b) and 457 plan maximum elective deferrals	$18,000	$17,500
Catch-up contributions	$6,000	$5,500
SIMPLE plan maximum elective deferrals	$12,500	$12,000
Catch-up contributions	$3,000	$2,500
IRA maximum contributions	$5,500	$5,500
Catch-up contributions	$1,000	$1,000
Highly compensated employee threshold	$120,000	$115,000
Key employee (officer) threshold	$170,000	$170,000
Social Security taxable wage base	$118,500	$117,000

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