Testing Testing Testing

One philosophy of regulation is to keep a close watch on the major movers and shakers at an organization to make sure they don't get too much of a good deal and leave the workers high and dry. The hope was that by restricting the benefits of the "big guys" to a certain relationship with the "little guys," the plans would be written in such a way as to bring the rank-and-file along. This is certainly the philosophy under ERISA, and there is a certain legitimacy to it.

Over time, however, we have discovered that ERISA's rules really only work well for large, bureaucratically capable organizations. Way too many small businesses have not chosen to offer a retirement plan to their workers. Today, almost five decades after ERISA over 40% of American workers do not have a retirement plan at work. Since the 1980's, Congress has tried to the help small businesses offer retirement plans by changing the philosophy of regulation from watching the big guys like a hawk to focusing on actually getting the little guys certain levels of benefits and not worrying so much if "the boss" is getting a good deal as well.

Thus, the state of regulation for retirement plans today is a mixture of ERISA's paternalism, especially for large organizations, with a certain amount of leniency, especially for small business.

Still, the first question to ask is, "Who are the "Big Guys?" – the major movers and shakers. In this context a lady can be a "big guy." There are two types of big guys: highly compensated employees and key employees. Little guys means rank-and-file (non-movers and shakers). Ladies can also be little guys in this thought process. The government's point for these categorizations under ERISA is to make sure the little guys are taken into account sufficiently when the employer plans are constructed. It is okay for big guys to get more than little guys in general, but the difference is limited to certain amounts.

Highly Compensated Employee (HCE): (for <u>minimum participation rules</u> and <u>group health insurance</u>). There are two independent tests for identifying who is an HCE: the ownership test and the compensation test. <u>You can become an HCE under either test</u>. Think of these tests as "<u>one and you're done</u>." The definition of HCE:

1. Ownership Test: You are a <u>**more than 5% owner**</u>. "Family aggregation rules" for a 401(k) count your spouse, and minor child. Adult children only count if the parent owns more than 50% with the aggregation. For example, you own 3% of Apple. Your spouse owns 2%. Your 30-year old child owns 1% and your 10 year-old child owns 0.1%. You are a highly compensated employee because your own 5.1% according to the family aggregation rules.

   Who doesn't count? Siblings or grandchildren. If the grandparent owns more than 50%, then the grandchildren count.

   The important point is knowing the more than 5% owners are HCEs and that there are family aggregation rules.

2. Compensation Test: When determining who is an HCE by compensation, the law looks at both the previous year (called the "look back year") and the plan year under consideration (called the "determination year"). During the previous year, the worker made <u>more than $125,000 in 2019 and $130,000 in 2020</u>. If you are only given the 2020 compensation then $130,000 or more makes the person an HCE.

The law allows a firm to make a "20% election" for the compensation test. Note that the 20% election counts only for the compensation test, not the ownership test. The 20% election means only the top 20% of people in the plan can be considered HCEs by the compensation test. 20% means 20% of the humans. If 10 humans are in the plan, the top 20% at the two most highly paid. If 100 humans are in the plan it is the top 20 goombas by pay. Naturally, the top 20% would also have to make enough money to be considered highly compensated under the normal test. Thus, it the firm made the 20% election and everyone in the top 20% made $125,000 in 2019 or $130,000 in 2020, then they would all be HCEs. However, it someone in the top 20% made less than the required amount for their year, then those people would not be considered HCEs. In other words, <u>making the 20% election can only help reduce the number of people considered HCEs</u>.

Finally, if someone passes one of the two tests, then the other test does not matter. For example, the 20% election test can never erase someone who is an HCE under the ownership test. Also, employee compensation does not matter for the ownership test. Thus, if you own more than 5% of the organization, you are highly compensated even if your pay is only $20,000/year. On the other hand, if a test question asks if someone is a HCE and/or key employee, then you would have to run each test to match the answer sheet.

Key Employee: used for determining if a plan is <u>top heavy</u> or not and for <u>group life insurance plans</u>.

1. An employee who also <u>owns 5% or more of the company</u>.

2. An employee who is <u>paid more than $150,000 and owns at least 1%</u> of the firm.

3. An officer of the company making **more than** $185,000 from the company in 2020.

Note: <u>If you own more than 5%, then you are whatever kind of big guy that matters</u> (HCE or key employee).

After separating the big guys from the little guys, we turn our attention to actual retirement plan rules. The initial hurdle is getting into the plan in the first place. That is the eligibility test. Next we make sure a sufficient amount of little guys are in the plan. That is the participations rules.

Eligibility Test: How long can an eligible worker be kept out of the plan? Back in the day, administering a retirement was a major pain. Records were kept by hand, etc. Thus, employers didn't want to be forced to open an account for a worker who might not be there long. So employers were allowed to prevent people from getting into the plan for a certain amount of time if the employer wished. On the other hand, the government and the workers are thrilled if the plan makes people eligible to participate sooner. Also, behavioral finance is teaching us what a penalty is it for people to not be allowed into the plan initially and painlessly. It is far wiser to have auto-enrollment and put workers into the plan immediately so they don't have to make a decision. So, the longest a worker can be forced to wait before becoming eligible for the employer retirement plan is:

21 and 1 year for plans with vesting schedules (a year is counted as being 1,000 hours until 2023) 21 and 2 years for plans with immediate vesting schedules

Coverage Tests (Participation Tests):

Just because a person is eligible to be part of a retirement plan does not mean the employer is required to include the worker in the retirement plan. However, the IRS requires that employers have a reasonable basis for excluding some people that is not discriminatory. Some examples that might be reasonable according to the IRS are: geographic area; type of compensation (salary versus 100% commission; and job titles. However excluding groups of employees who are eligible can mean the plan will not pass any of the coverage tests. That would mean the plan is no longer a qualified plan. There are procedures to correct participation failures and restore the qualification of the plan, but they are beyond the scope of the test.

There are "three and a half" coverage tests/participation tests. The first three apply to all qualified plans (percentage test; ratio percentage test; and average benefits test). The 50/40 test only applies to defined benefit plans. That is why I think of it as half a test.

Passing a test means that the plan is in compliance on at least one day per tax quarter.

1. **Percentage Test** ("Safe Harbor Test" – but not the safe harbor 401(k) test): 70% or more of eligible NHCEs must be in the plan to pass the percentage.

2. **The Ratio Percentage Test (aka The Ratio Test)**: the percentage of NHCEs who benefit from the plan must be at least 70% of the percentage of highly compensated employees who benefit from the plan. For example, if 90% of the highly compensated employees are in the plan, then at least 63% of the non-highly compensated employees must be in the plan.

   One way to check for compliance is to always multiply the percentage of the HCEs times 0.7. This is the minimum percentage of the NHCEs that must be in the plan.

   For example, your company has 10 highly compensated employees and 50 eligible non-highly compensated employees. If 8 of the HCEs are in the plan, what is the minimum number of NHCEs that must be in the plan to pass the ratio test?

   Answer: 28 For the little guys, only 70% of the 80% of the highly compensated employees must be in the plan, that's 56% of the little guys.
   50 x .56 = 28

3. <u>The Average Benefits Test</u>: there are two parts to this test.

   a. The "fair cross section" test. This test ensures that the plan does not discriminate in favor of highly compensated employees. The details are beyond the scope of the ourse (aren't you glad?).

   b. The second part of the average benefits test is that the average employer-provided contributions (including forfeitures from people leaving the plan before they are fully vested) or benefits for non-highly compensated employees must be at least 70% of the average benefit for highly compensated employees. For example, if the highly compensated employees average 10% of their salary as an employer contribution to the plan, then non-highly compensated employees must get at least 7% of their meager salaries contributed to the plan to pass this test.

      For example, there are two employees. One is the founding owner making $100,000/year and the janitor making $10,000/year. If the founding owner is saving 10% then the janitor needs to be saving 7%. So the founding owner agrees to put 7% into everyone's 401(k). What does it really cost the owner? $700 into the janitor's account lets him save $10,000 into his own because we are dealing with percentages. With small businesses the amount the owners need to save can have an impact on the match. The match helps get the contributions for the NHCEs up to where the owners are allowed to defer the percentage the need for their retirement. That would be ERISA working well for everyone.

Notes on the three minimum participation tests:

- A conglomerate may satisfy these tests by combining comparable plans throughout the company.
- Ineligible employees are not counted when determining the percentages. Ineligible employees are under 21, have less than a year of service, or are covered by a union plan/collective bargaining agreement.)

<u>For defined benefit plans only</u>, there was a fourth minimum participation rule. It is the 50/40 Test ("minimum coverage test"). This test excludes the same ineligible groups. The **50/40 Test** requires that the defined benefit plan cover at least the <u>lower</u> of:

a. **50 people** or

b. The <u>greater</u> of **40% of the company's workers or two workers**. Companies with only one employee would pass the 40% test because the one worker would be in the plan or there won't be a plan to be concerned with. <u>If there are two employees, then both must be in the plan</u>. I remember this rule by "putting people before percentages." Its 50 people and 40%. <u>The type of people or employees doesn't matter for this participation test</u>.

ACP/ADP tests for 401(k) plans

401(k)s have an addition test. If the employer makes non-elective contributions to anyone's account, the contributions must meet **one** of these additional tests.

1. The 125% Test: The average deferral percentage (ADP) for HCEs cannot exceed 125% of the ADP for NHCEs.

2. The 200%/2% Max Test: The ADP for HCEs cannot exceed 200% of the ADP of NHCEs and the difference between the two ADPs cannot exceed 2%.

Note that you only have to meet one of these tests and the big guys don't want to be restricted, so the test that gives the higher amount wins.

What is the difference between the ADP and the ACP tests?

1. The Average Deferral Percentage/ADP test is the more basic test because it only counts what the employees are deferring from their own salary. The real question in the ADP Test is, "In general, how much are the workers putting into the 401(k) from their own pocket?"

   Some employee deferrals don't count with the ADP test. They are after-tax deferrals and age 50 catch-up contributions. After-tax deferrals are when a worker puts money into the 401(k) but does not deduct the contribution from current salary. This is like a nondeductible IRA contribution. Before Roth elective deferrals it would be smart to not deduct your contribution if your income was so low that you would not pay any tax at all either way. For example, you are single and earning less than the standard deduction. Your income tax bill would be zero whether you deducted your contribution or not, so why not forgo the deduction now and not pay income taxes when this principal is withdrawn? Today, these people should be making Roth elective deferrals. Roth elective deferrals do count under the ADP test.

   The reason the ADP tests do not count age 50 catch-up contributions is because the ADP Test is about what people are basically putting aside for their future. Adding the worker's age into the equation would muddy the picture of how much most people are saving at the employer.

2. The Average Contribution Test/ACP test measures how much is going into the employees' accounts from all sources except catch-up contributions. Thus, all types of employer contributions (both nonelective contributions and matching contributions are considered. So are after-tax contributions.

What happens if a 401(k) fails ADP/ACP testing?

1. The plan can make corrective contributions. The means giving back the HCEs contributions until the plan passes the ADP/ACP tests. However, big guys don't like

getting back retirement plan contributions (and the earnings on those contributions, so they would be motivated to select #2.

2. The firm could make qualified matching contributions (QMACs) or qualified nonelective contributions. (QNECs). Basically, these or “Oh no!” contributions that being the 401(k) into compliance with the ADP/ACP tests. These QMACs and QNECs must always be 100% immediately vested. Essentially the law says if the firm is cutting it this close, the workers get vested immediately in these contributions even if they are not fully vested on other matching or nonelective contributions.

How to Actually Do the ADP and ACP Tests

These tests look very tedious at first. However, simply multiply the NHCE’s contribution percentages by 1.25 and write that number down. Then double the NHCE’s contribution, then limit the difference to 2% and write that down. The large number in the limit because you only have to pass one test.

For example, the NHCEs average 6%? What is the most the HCEs can average?

125% Test: 6 X 1.25 = 7.5%

200% Test (Limited to 2% Maximum): 6% X 2 = 12, but the 2% max difference means this test stops at 8% (6 + 2 = 8).

8 is more than 7.5 so 8% wins. Easy peazy. This questions appear to be very difficult but they are really just a matter of remembering the two tests (125% and 200% limited to 2% max) and then working your way through the tests to pick the higher final number.