FAQ About Testing

The Internal Revenue Service (IRS) mandates a variety of tests be met in order for a Qualified Retirement Plan to maintain its tax deferred status. The tests are as follows:

Average Deferral Percentage (ADP) test & the Average Contribution Percentage (ACP) Test

These two tests compare the contributions of pre-tax deferrals, Roth deferrals and employer matching contributions made by the "highly compensated employees" (HCEs) to the contributions made by the Non-Highly Compensated Employees (NHCEs). These tests could limit the amount of 401(k) salary deferrals and/or Roth contributions a HCE can make. A HCE is defined as:

- A 5% owner in the current testing year 2018 or prior year 2017
- An immediate family member of an owner who is also an eligible employee is considered a HCE.

  Immediate family members include: spouse, children, parents, and grandchildren.
- An employee who earned more than $120,000 in the prior year of 2017.

  For example: if John Smith owns 100% of ABC, Inc. and his wife June and son Jim are eligible employees of ABC, Inc., June and Jim would also be Highly Compensated Employees.

There are two methods to complete the ADP/ACP tests.

1) **Prior Year Testing Method:** This method compares the current year average ratio of the HCEs to the prior year average ratio of the NHCEs.
2) **Current Year Testing Method:** This method compares the current year average ratio of the HCEs to the current year average ratio of the NHCEs.

How do you calculate the average deferral and match ratios?

To arrive at the ratio for the ADP test, start with each participant's total 401(k) deferral plus the total Roth 401(k) contribution (if applicable) divided by the gross compensation earned for the plan year.

To arrive at the ratio for the ACP test, start with each participants employer match contribution divided by the gross compensation earned for the plan year.

Are 401(k) catch-up contributions included in the ADP test?

No, 401(k) catch-up contributions are not included in the ADP Test.

What happens if your plan does not pass the ADP/ACP tests?

Excess contributions resulting from a failed ADP test must be refunded to the participant.

How are ADP and/or ACP refunds calculated?

The amount of any potential refund is based on various factors, including a HCE's deferral percentages and deferral amounts.

What happens if a HCE receiving a refund is eligible to make catch-up contributions?

If an HCE is catch-up eligible, and has not already deferred all, or a portion, of their catch-up contribution, it is possible their refund can be reduced or eliminated if it is re-characterized as a catch-up contribution. This means that deferral will remain in the plan.

However, keep in mind that if a participant has deferred all, or a portion, of their catch-up contribution, they could still receive a refund.

For example if an HCE deferred $24,500 ($18,500 in 401(k) contributions plus $6,000 in 401(k) catch-up contributions) the individual will receive a refund.

> ***If a participant is age 50 or older or will be turning age 50 during 2018, the individual can defer additional 401(k) and/or Roth contributions as catch-up contribution.***

****Mary Gawronski, your BeneTrak, Inc. Compliance Manager, can answer your questions on possible refund calculations and catch-up contributions.**

How are ADP and/or ACP refunds taxed?

The refunds are taxable to the participant in the year distributed.

> **For Example**: For the 2018 plan year testing, excess contributions, whether refunded prior to March 15, 2019 or after, are taxable in the year distributed. Refunds of excess contributions will be taxable to the participant in 2019.

When do refunds need to be made to the participants?

- Excess contributions need to refunded within 2 ½ months after the close of the plan year. For plans with a December year end the deadline is ***March 15th***.

Are there penalties if refunds are made after the 2 ½ month deadline?

If excess contributions are refunded <u>after</u> the 2 ½ month deadline or March 15th, the employer will be subject to a 10% excise tax penalty.

Deferral Limits (IRC402(g)) or Deferring More Than $18,500 in 2018

This is a calendar year limit. For the 2018 calendar year, the deferral limit is $18,500. If the participant is age 50 or is turning age 50, the individual can defer an additional $6,000.

If a participant exceeds the deferral limit, does a refund need to be made?

Yes, if a participant exceeds the deferral limit of $18,500, a refund must be made to the participant by April 15th.

How are deferral limit refunds taxed?

The deferral contribution is taxed in the year contributed. This means that if the excess deferral was contributed in 2018, only the contribution amount is considered as income for the 2018 tax year.

The earnings on the contributions are taxed in the year distributed. This means if the excess deferral is corrected in 2019, the earnings are taxable for the 2019 tax year.

415 Annual Additions Test

What makes up the total for annual additions limit?

This test determines whether or not the annual additions contributed to a participant's account exceed the lesser of 100% of annual gross compensation or $55,000. The contributions used in this test include:

- 401(k) and/or Roth 401(k) Contributions
- Employer Match Contributions
- Profit Sharing Contributions

Top-Heavy Test

This determines whether 60% or more of the account balances are in the hands of the key employees. A key employee is:

- A 5% or more owner in the current testing year (2018).
- An immediate family member of an owner who is also an eligible employee is considered to be a Key Employee. Immediate family members include: spouse, children, parents, and grandchildren.
- A 1% owner who earns more than $150,000
- An officer, who earns more than $175,000 and has the authority to legally bind the corporation.

What happens if the plan is deemed Top-Heavy?

A Top-Heavy minimum contribution of 3% is required to be made to the non-key employees.

410(b) Coverage Testing

This tests whether your plan sufficiently benefits a cross section of your employees. The coverage tests compares the average ratio of the NHCEs benefiting to average ratio of HCEs benefiting.

- The most common test is the Ratio Percentage Test. This test passes if at least 70% of the NHCEs benefit under each source in the plan.