

Keeping your plan in shape

TIAA's Nondiscrimination Testing Guide

2022



Table of contents

Introduction	3
1. Key Terms and Concepts	5
Plan Definition of Compensation	6
Limit on Includable Compensation	6
Compensation Ratio Test	7
Social Security Integration	8
Permitted Disparity Safe Harbors for Noncontributory Plans	9
Related Industry Service	10
Contributions for Former Employees (for 403(b) plans)	10
Plans Covering Otherwise Excludable Employees	11
Leased Employees	12
2. Minimum Coverage Tests	13
3. General Nondiscrimination	19
How to test your noncontributory plan for General Nondiscrimination	20
How to test your voluntary contributory plan for General Nondiscrimination	24
4. ACP (Matching) Test	26
5. Actual Deferral Percentage (ADP) Test	31
6. Design-Based Safe Harbors	36
7. Universal Availability Rule	41
8. Sample Plans	43
9. Appendix	48
A. Glossary of terms	49
B. Plan Outline	61
C. Sanctions for Failing	62
D. Treatment of Collectively Bargained Employees	62
E. Plan Requirement Summaries	63
F. Nondiscriminatory Classification: Safe and Unsafe Harbors	64
G. Contribution and Compensation Limits	64

Note: All page numbers referenced throughout this guide are hyperlinked for your convenience.

Introduction

This guide is designed to provide education and assistance to help you better understand the nondiscrimination testing requirements and how to apply them to your ERISA covered plans with confidence and accuracy (ERISA is the Employee Retirement Income Security Act of 1974). It explains the nondiscrimination requirements, provides step-by-step instructions on how to perform the applicable nondiscrimination test, and offers suggestions on how to comply if your plan fails the test.

As always, TIAA strongly encourages you to discuss any nondiscrimination requirements for your plan(s) with your legal counsel.

This guide provides assistance for the nondiscrimination testing for:

- ERISA covered Internal Revenue Code section 403(b) plans, and
- Qualified ERISA defined contribution plans, (e.g., IRC section 401(a), 403(a) and 401(k) plans)

How to use this guide

The IRC and Treasury regulations make it clear that failing to meet nondiscrimination requirements is a plan defect that could result in incurring a tax consequence (including both HCEs and NHCEs), in the year the plan first fails.

This guide is intended to provide assistance with understanding the requirements and show examples of how to meet them.

Each section includes a summary that answers these key questions:

- “Who has to perform this test?”
- “When do we have to do this?”
- “What is the impact if we fail?”

Also in this guide:

- **Examples** to help you perform each test
- Explanations of the IRC requirements and regulations
- **Glossary of terms**
- Sample plans answering the question: “What kind of plan passes easily?”

Of course, all interpretations in this guide reflect our current guidance of the application of these rules. Because TIAA cannot provide legal, tax or accounting advice, TIAA strongly encourages you to address any nondiscrimination testing requirements for your specific plan(s) with your legal counsel.

Tips for navigating the guide:

- Use the **page jumps** to skip to relevant content
- Click on bold links for a deeper dive
- Get started: Jump to **page 49** for a glossary of terms

Introduction

What is nondiscrimination testing?

Nondiscrimination testing is a series of tests required by the IRS to verify that the distribution of plan benefits is done fairly and equitably. Problems with nondiscrimination testing are among the top ten issues uncovered during IRS audits.

Primary components of nondiscrimination testing

General Nondiscrimination: Requires that plans not discriminate against non-highly compensated employees (NHCE) with respect to contributions and availability of other benefits, rights and features.

Plan amendments and terminations must not result in discrimination in favor of highly compensated employees.

Minimum Coverage: Requires that the percentage of highly compensated employees (HCE) benefiting under the plans not be unduly high in comparison to the percentage of non-highly compensated employees benefiting under the plan.

Requirements by plan type

Fortunately, not every test applies to every plan. The following table lists the nondiscrimination testing requirements and safe harbors, and explains the types of plans to which each applies.

Requirement	Plans affected
Minimum Coverage (Section 2)	All contributory and noncontributory plans must satisfy either the Ratio Percentage Test or the Average Benefits Test.
General Nondiscrimination (Section 3)	All contributory and noncontributory plans.
ACP (Matching) Test (Section 4)	Plans that allow employee after-tax contributions. Voluntary contributory plans, except if: <ul style="list-style-type: none">▪ The plan qualifies for one of the design-based safe harbors.▪ As a condition of employment, employee contributions are mandatory.▪ Irrevocable salary deferral agreements are used.
ADP Test (Section 5)	Voluntary contributory 401(k) plans except those that qualify for one of the design-based safe harbors. This test is not applicable to 403(b) plans.
Design-Based Safe Harbors (Section 6)	Available to voluntary contributory plans.
Universal Availability Rule (Section 7)	<ul style="list-style-type: none">▪ All voluntary contributory 403(b) plans. This rule is not applicable to 401(a) plans.▪ All supplemental 403(b) plans that provide for employee elective deferrals (both pretax salary reduction and, if permitted by the plan, after-tax Roth 403(b) contribution).

Public and governmental retirement plans are generally considered to automatically meet most nondiscrimination requirements without testing. However, 403(b) plans that permit voluntary employee elective deferrals, including public 403(b) plans, are subject to the Universal Availability Rule (page 41). And all retirement plans (except for certain church plans) are subject to the 401(a)(17) limit on the maximum amount of compensation that can be taken into account when calculating retirement plan contributions (page 64).

What happens if you ignore these tests and your plan does not comply?

Treasury regulations indicate that failure of the nondiscrimination tests is a plan failure that can cause the entire plan to lose its tax-favored status. If the IRS does not disqualify the entire plan and imposes tax consequences to all employees, it might impose a tax consequence on your highly compensated employees (including your President or CEO).

Section One: Key Terms and Concepts

Highly Compensated Employee (HCE) and Non-Highly Compensated Employee (NHCE)

A retirement plan is considered to be discriminatory if HCEs are unduly favored in terms of contributions, optional forms of benefits or other plan rights and features. No employee is considered to be an HCE unless he or she received compensation in the prior plan year above the applicable amount for that plan year. (See [page 55](#) for a more detailed explanation plus an alternative definition.)

For purposes of determining who is an HCE or for calculating contribution percentages, it is essential to use a correct definition of compensation. Generally W-2 wages as reported in Box 5 on the employee's W-2 (Medicare wages) should be used for testing purposes even though another definition may be used for purposes of calculating contributions to the plan. (See [page 49](#) for a more complete explanation of definitions of compensation that can be used for testing purposes and [page 6](#) for a discussion of plan definitions of compensation.)

A plan covering only non-highly compensated employees (NHCEs) is deemed to automatically meet all nondiscrimination requirements without testing. (See [page 55](#).)

The IRS identifies two tests for determining if an employee is an HCE—an ownership test and a compensation test. An employee is an HCE if they satisfy either of the two tests. [Learn more](#)

Excludable employees

Some types of employees, such as those who have not satisfied the plan's waiting period, can be disregarded when conducting nondiscrimination testing if no employees in the category are receiving contributions. (See [page 53](#) for a list of categories of excludable employees.)

Union Employees

Collectively bargained (i.e., union) employees must generally be tested separately from non-union employees, even if the union and non-union employees are in the same plan. If an employer has multiple union plans, then each union plan is tested separately. Nondiscrimination regulations provide that union plans automatically meet the testing requirements, under most circumstances (see [Appendix D, page 62](#)).

Aggregate vs. separate nondiscrimination testing

For an institution that sponsors more than one retirement plan, one of the first steps in applying the nondiscrimination requirements is to determine whether the plans should be aggregated or tested separately. (See [page 51](#) for help in making this determination.)

Contributory vs. noncontributory plans

A retirement plan is generally considered to be contributory if it allows for employee contributions to the plan. (See [page 51](#) for exceptions to this rule.)

In order to be considered to be benefiting from a noncontributory plan, an employer contribution must be made to the plan for the employee. But for a contributory plan, an employee is generally considered to benefit as long as he or she is eligible for the plan, whether or not actually participating. (See [page 49](#).)

Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) Testing

For plans subject to the Actual Deferral Percentage (ADP) Test and/or the Actual Contribution Percentage (ACP) Test (also known as the Matching Test), the average deferral or contribution percentages for NHCEs can be calculated using either current or prior year compensation and contribution data.

Institutions that used the Current Year testing method in previous years can elect to change to the prior year testing method, as long as the current year testing method was used for testing in each of the five preceding plan years.

Institutions that have elected to conduct the ADP and/or ACP Tests using the Prior Year testing method can elect to change to the Current Year testing method at any time, even if the Prior Year testing method was not used in each of the preceding five plan years.

The institution's plan document should reflect the testing method currently being used. The average deferral and contribution percentages for HCEs are always calculated using current year compensation and contribution data even if the Prior Year testing method is used for calculating percentages for the NHCEs.

Section One: Key Terms and Concepts

Plan Definition of Compensation

The definition of compensation your plan uses for calculating contributions for contributory and noncontributory plans can have a major impact on test results.

You aren't required to use a nondiscriminatory definition of compensation for purposes of calculating plan contributions. However, you must use a nondiscriminatory definition for purposes of applying the amount of contributions portion of the General Nondiscrimination Test, for the Average Benefits Percentage Test, and when conducting the ADP (for 401(k) plans) and ACP Tests.

Using one of the definitions specified in the nondiscrimination regulations as your plan definition for purposes of calculating contributions gives you a better chance of passing these tests, since you can also use the plan definition for testing purposes. If you don't use one of the definitions of compensation specified in the regulations, then the plan's definition must be reasonable, not favor HCEs by design, and pass the Compensation Ratio Test described on the next page if you want to use it for testing purposes. (See **page 49** for a list of nondiscriminatory definitions.)

Otherwise, if your plan's definition of compensation is considered discriminatory, you need to determine effective contribution rates based on a nondiscriminatory definition of compensation when testing your plan.

Limit on Includable Compensation

The maximum amount of an individual's compensation that can be taken into account for purposes of calculating retirement plan contributions in a plan year is limited by regulation. Furthermore, when applying the nondiscrimination tests (i.e., General Nondiscrimination, Average Benefits Percentage, ACP, or ADP), the maximum amount of an employee's compensation that can be considered is subject to the plan year limit.

Appendix G shows the IRC Section 401(a)(17) includable compensation limits by year (for a plan year that begins in the calendar year shown).

If you are considering:

a. the **Design-Based Safe Harbors** as an alternative to the ADP and ACP Tests

or

b. satisfying the **safe harbor rules** under General Nondiscrimination

Then use a nondiscriminatory definition of compensation for calculating your plan contributions

Section One: Key Terms and Concepts

Compensation Ratio Test

Step 1

- Sort all eligible employees by HCE or NHCE classification. For each employee, calculate the compensation ratio by dividing his or her plan formula “compensation” by a definition of compensation specified in the regulations (which will usually be the employee’s box 1 W-2 compensation plus any salary deferrals or the box 5 amount without adjustment). Alternatively, you may test based on all employees, including ineligible ones, unless it results in a distortion that is more than de minimis.
- Calculate the average compensation ratio for all eligible NHCEs and separately for all eligible HCEs.

Example

NHCE	<u>Regular salary</u> Total compensation	=	% of total compensation
A	\$15,000/\$18,700	=	80%
B	\$20,000/\$22,500	=	89%
C	\$25,000/\$25,000	=	100%
W	\$40,000/\$40,000	=	100%

NHCE average = 92.25%

HCE	<u>Regular salary</u> Total compensation	=	% of total compensation
X	\$136,500/\$150,000	=	91%
Y	\$130,000/\$130,000	=	100%
Z	\$110,500/\$130,000	=	85%

HCE Average = 92%

Step 2

Compare the average compensation ratio of the HCEs and the NHCEs. If the HCE average doesn’t exceed the NHCE average by more than a de minimis amount, the definition passes the test.

Example

NHCE Average (92.25%) > HCE Average (92.00%); therefore, the Compensation Ratio Test is passed, and the plan’s definition of compensation may be used for nondiscrimination testing to make testing easier. If the HCE average is only higher because of additional compensation due to an extraordinary and unforeseeable event (e.g., a natural disaster), you may still pass if the HCE average didn’t exceed the NHCE average by more than a de minimis amount in prior years.

Example

The HCE average at XYZ College exceeded that of the NHCE average by a considerable margin in the year that the campus was hit by a tornado because of the extraordinary amount of overtime pay accrued by the maintenance staff. In prior years, overtime was minimal and the HCE and NHCE compensation averages were virtually identical.

Section One: Key Terms and Concepts

Social Security Integration

Some retirement plans are “integrated” with Social Security, i.e., they provide a higher contribution rate for compensation above some stated amount (the “integration level”) than for compensation below that point. This difference in contribution rates is called “disparity.”

Integrated Contributory Plans

Because you can't count Social Security contributions when conducting the ACP Test, employees will have different rates of matching contributions under an integrated plan. The right to each rate of matching contributions is a plan feature that must be tested for nondiscriminatory availability. As HCEs will have a higher rate of match under an integrated formula, these plans will fail the benefits, rights and features portion of the General Nondiscrimination Test when this test is applied. These plans should not be designed with an integration formula.

Integrated Noncontributory Plans

If the difference between contribution rates above and below the integration level is within the “permitted disparity” limits (see [page 9](#)), and contributions are otherwise a uniform percentage of a nondiscriminatory definition of compensation, an integrated noncontributory plan is eligible for the safe harbors under the General Nondiscrimination Test (see [page 20](#)).

If a plan doesn't stay within the permitted disparity limits or doesn't allocate contributions based on a nondiscriminatory definition of compensation, it will have to rely on the General Test to meet the requirements of the General Nondiscrimination Test (see [page 21](#)). While such a plan can't rely on the safe harbors, it can still impute permitted disparity under the General Test.

Permitted Disparity Safe Harbors for Noncontributory Plans

Step 1

For each integrated noncontributory plan, determine the integration level, the basic contribution percentage and the excess contribution percentage that applies to compensation above the integration level.

Step 2

a. Integrated at the Wage Base

If your plan integrates employer contributions at the Wage Base for the OASDI portion of Social Security (SSWB), you can provide an additional contribution on pay above the SSWB of up to the lesser of (a) 5.7% or (b) the base contribution percentage.

Example

Plan A:	
Integration level	SSWB
Base contribution %	5%
Excess contribution %	10% (a 5% disparity)

Maximum permitted disparity = lesser of 5% or 5.7% actual disparity = 5%; therefore, the permitted disparity test is met

b. Integrated below the Wage Base

i. If your plan integrates employer contributions at a level less than 100% but more than 80% of the current SSWB, the maximum additional contribution is the lesser of (a) 5.4% or (b) the base contribution percentage.

Example

Plan B:	
Integration level	90% of the SSWB
Base contribution %	8%
Excess contribution %	13.4% (a 5.4% disparity)

Maximum permitted disparity = lesser of 8% or 5.4% actual disparity = 5.4%; therefore, the permitted disparity test is met

ii. If your plan integrates employer contributions at a level less than 80% of the SSWB, but more than 20% of the SSWB, you can provide an additional contribution on pay above that level of up to the lesser of (a) 4.3% or (b) the base contribution percentage. (This range includes plans which integrate at the Social Security Second Bend Point.)

Example

Plan C:	
Integration level	one-half the SSWB
Base contribution %	6%
Excess contribution %	10% (a 4% disparity)

Maximum permitted disparity = lesser of 6% or 4.3% actual disparity = 4%; therefore, the permitted disparity test is met

iii. If your plan integrates employer contributions at or below 20% of the SSWB, you can provide an additional contribution on pay above that level of up to the lesser of (a) 5.7% or (b) the base contribution percentage.

Example

Plan D:	
Integration level	10% of the SSWB
Base contribution %	10%
Excess contribution %	15.7% (a 5.7% disparity)

Note: Plans integrated above the current SSWB aren't eligible for the IRC section 401(a)(4) safe harbors.

Section One: Key Terms and Concepts

Related Industry Service

Many institutions require new employees to satisfy a waiting period (e.g., one year) before they become eligible to participate in their retirement plans. However, some of these plans give employees “credit” against the waiting period for time previously worked at another college or university (i.e., give credit for prior “related industry service”).

Prior to the issuance of the final 401(a)(4) regulations, it wasn’t entirely clear whether institutions that credited employees’ prior “related industry service” toward the waiting period requirement could—for Minimum Coverage Testing purposes—exclude other employees who hadn’t yet satisfied the requirement. Since new employees tend to be NHCEs, this could have led to failures under Minimum Coverage Testing.

Final 401(a)(4) regulations explicitly allowed institutions that count prior service at other schools to exclude from Minimum Coverage Testing the employees who haven’t satisfied the waiting period requirement, provided that:

- All similarly situated employees are treated equally (e.g., if faculty and administrators are granted credit for prior service at other schools, clerical and maintenance workers must be granted credit too);
- There is a legitimate business reason for crediting prior service (e.g., institutional efforts to recruit experienced faculty); and
- The policy doesn’t result in significant discrimination in favor of HCEs, given all relevant facts and circumstances.

Contributions for Former Employees (for 403(b) plans)

Nonelective employer contributions can be made to a 403(b) plan for up to five years following an employee’s severance from employment. For plans other than governmental and church plans, these contributions will be subject to separate nondiscrimination testing. Former employees must be tested separately from current employees. This special rule which permits contributions for certain former employees is not available for former participants in 401(k) or other qualified plans.

For nondiscrimination testing purposes, a former employee is an individual who has ceased to perform services as an employee for his or her former employer. Former employees will be considered HCEs if they were highly compensated when they terminated or at any time after attaining age 55.

The Treasury regulations issued under IRC section 401(a)(4) provide a simplified facts-and-circumstances method for testing former employees. Under this method, contributions to former employees are generally considered nondiscriminatory as long as they don’t result in significant discrimination in favor of HCE employees.

For the typical institution with a retirement plan funded with TIAA annuity contracts or mutual funds, generally the only former employees who continue to receive contributions after they stop performing services are those who retire under an early retirement incentive plan or who are on sabbatical, leave of absence or long-term disability.

In addition to the nondiscrimination requirement, the institution should also be sure that contributions for former employees aren’t exceeding the IRC section 415 limits on contributions. If you are considering contributions to certain former employees under your IRC section 403(b) plan, we encourage you to consult with your legal counsel to confirm that such contributions are consistent with the terms of the your plan and the applicable guidance including, but not limited to, the guidance pertaining to non-discrimination.

Section One: Key Terms and Concepts

Plans Covering Otherwise Excludable Employees

Certain categories of employees can be excluded from participation in your plan(s). If your plan is going to exclude a category of employees from participation in the plan, you must provide for that specific exclusion under the terms of your written plan. If the plan provides for the exclusions of a permitted category of employee, you do not have to count such excluded employees for plan testing purposes, but only if none of the employees in that category benefit under the plan. If any one employee of the otherwise excludable group benefits from the plan, then none of the employees in that category can be excluded from the testing population because they belong to that category. Also, if the written plan does not explicitly provide for the exclusion, then the exclusion does not exist.

Excludable categories include those employees who don't meet plan age or service requirements, certain student-employees, employees normally working fewer than 20 hours per week, collectively bargained employees and nonresident aliens. Note that not all of the exclusions indicated in this paragraph are available for all plan types. (See the definition of excludable employee/nonexcludable employees on **page 53** for more categories.)

If a plan does not have a minimum age or service requirement, or if the plan waives the age or service requirement for some employees, then the plan can't take advantage of the exclusion. As an alternative, however, the plan may be tested for compliance with nondiscrimination requirements as if it were two plans: one for employees who do not meet the minimum statutory age and service requirements of IRC section 410(a)(1)(A) (i.e., age 21 and one year of service) and another plan for all the other employees benefiting from the plan. When testing the plan for the employees who have satisfied the minimum age and service requirements of IRC section 410(a)(1)(A), the employees who don't satisfy the requirements are treated as excludable employees. This rule applies for the coverage, ADP and ACP Tests. Before making the decision any plan with an age and/or service requirement as two plans, you should engage your legal counsel to make sure that doing so is consistent with the terms of your plan and the applicable guidance for your plan type.

In addition, an employee not benefiting from a plan because they have not yet satisfied its service requirement, cannot be treated as an excludable employee if the service requirement is waived for some employees. However, if the plan is an IRC section 403(b) plan, and the written plan excludes employees who are expected to work less than 20 hours per week, and any employee who is expected to work less than 1,000 hours in the next 12 month period, beginning at the time they would otherwise be eligible to participate, may be excluded from the plan. At the end of the 12 month period, the plan sponsor must look back and, if an excluded employee did, work 1,000 hours or more, that employee must be given the opportunity to participate prospectively.

Example

XYZ's contributory IRC section 401(k) retirement plan does not have a waiting period or a minimum age or service requirement for eligibility. The plan fails the ACP tests, or the ACP and ADP tests because many newly hired employees do not participate in the plan even though they are eligible. The plan will satisfy the nondiscrimination requirements if it can be divided into two separate plans, and:

- 1 The plan covering only employees who are under age 21 and have less than one year of service (i.e., haven't met the minimum age and service requirements of IRC section 401(a)(4)) can pass the nondiscrimination tests on its own, and
- 2 The plan covering employees who have met the IRC section 401(a)(4) minimum age and service requirements can pass the nondiscrimination tests on its own.

In most cases, both plans will meet nondiscrimination requirements and, if all HCEs have satisfied the age 21 and one-year-of-service requirements, the plan covering only employees who have not met these age and service requirements will automatically meet all nondiscrimination requirements without testing since there are no HCEs benefiting from this plan.

Section One: Key Terms and Concepts

Leased Employees

Many employers don't provide their own food service or building and grounds employees, but lease them from an outside organization. The law doesn't require you to provide retirement benefits to leased employees but, if your institution is the recipient of their services, you may have to count them for nondiscrimination testing. Counting leased employees can create issues for small organizations if the leased employees constitute a large proportion of organizations NHCE's and they can't be excluded.

A leased employee is treated as an employee of the recipient institution and must be included when conducting nondiscrimination testing if:

- 1 There is an agreement (written or oral) between the leasing organization and the recipient,
- 2 The services are performed on a substantially full-time basis for at least one year, and
- 3 The services are performed "under the primary direction or control" of the recipient.

For leased employees, substantial full-time service is at least 1,500 hours of service a year or 75% of the median number of hours credited to employees performing similar work.

Individuals who don't meet the statutory definition of leased employees still may be treated as employees of the recipient if a common-law employer-employee relationship exists. Hiring, firing and exercising control over the employee's activities indicate a common-law relationship.

Safe Harbor Plan. If less than 20% of your work force is made up of leased employees, you don't have to count those leased employees when performing nondiscrimination testing, if they are covered under a retirement plan that is structured as a safe harbor retirement plan of the leasing organization. The leasing organization's plan meets the safe harbor requirements if it:

- 1 Provides a level employer contribution rate of at least 10% for all eligible employees,
- 2 Provides immediate participation, and
- 3 Is immediately 100% vested.

Section Two: Minimum Coverage Tests

? Does this test apply to my plan(s)?

Applies to:

ALL contributory and noncontributory plans

To demonstrate that plan participation does not favor HCEs over non-HCEs all contributory and noncontributory plans must satisfy one of two tests:

- 1 **The Ratio Percentage Test** compares the proportion of non-highly compensated employees (NHCEs) that are benefiting under a plan to the proportion of highly compensated employees (HCEs) that are benefiting.
- 2 **The Average Benefits Test** compares the ratio of NHCEs benefiting and benefits received by these employees to the comparable figures for HCEs.

Who?

Generally, contributory and noncontributory retirement plans are tested separately. If an employer has both a qualified plan and a 403(b) plan, the qualified plan is generally tested separately, but when testing the 403(b) plan for Minimum Coverage, the qualified plan can be taken into account. If General Nondiscrimination requires that you test your noncontributory plan by rate groups, then each rate group must satisfy minimum coverage on its own (see [page 21](#)).

When?

You may select any day during the plan year that is reasonably representative of workforce composition and plan coverage to run your test (see [page 60](#) for a definition of “snapshot testing”). Under certain circumstances testing may be as seldom as once every three years as long as there haven’t been any significant changes since the last test date, e.g., changes in legal requirements, plan provisions, or employee population or participation (see [page 60](#) for a definition of “three-year testing”).

Impact?

If any plan fails to satisfy either the Ratio Percentage Test or the Average Benefits Test and no correction is made, HCEs and perhaps NHCEs as well, could be taxed on contributions made during the year the plan fails. However, plans have until the 15th day of the 10th month after the end of the plan year to correct the failure by expanding coverage. You should always consult with your legal counsel to ensure that you are timely and appropriately testing your plan(s).

Summary

To satisfy the Ratio Percentage Test, the percentage of NHCEs benefiting under each plan or aggregation of plans must be at least 70% of the percentage of HCEs benefiting under that plan or aggregation. See [page 14](#) to find out how to test a plan for Ratio Percentage.

The Average Benefits Test applies a subjective and an objective test to employee coverage, then compares all benefits received to assure that NHCEs’ average benefits are at least 70% of HCEs’ average benefits. See [page 15](#) to test a plan for Average Benefits, but try Ratio Percentage first; it’s easier.

Section Two: Minimum Coverage Tests

How to test a plan for Minimum Coverage: Ratio Percentage Test

For each plan to be tested:

Step 1

- Determine the total number of nonexcludable employees¹ and calculate how many of them are HCEs and NHCEs.
- Determine how many HCEs and how many NHCEs benefit under the plan.

Example

Total employees 115
Excludable employees – 15
Nonexcludable employees 100

	Nonexcludable employees	Employees benefiting
HCEs	25	20
NHCEs	75	50

¹ See definition of excludable employee on page 54.

Step 2

- Determine the percentage of NHCEs benefiting under the plan by dividing the number of NHCEs benefiting by the total number of nonexcludable NHCEs.
- Determine the percentage of HCEs benefiting under the plan by dividing the number of HCEs benefiting by the total number of nonexcludable HCEs.
- Divide the percentage of NHCEs benefiting [2(a)] by the percentage of HCEs benefiting [2(b)]. This is the plan's "ratio percentage." If the plan's ratio percentage [2(c)] is at least 70%, the plan passes the Ratio Percentage Test and, therefore, satisfies Minimum Coverage requirements. Proceed with General Nondiscrimination testing (see Section 3).

Example

- NHCE percentage = $50/75 = 67\%$
- HCE percentage = $20/25 = 80\%$
- $\frac{\text{NHCE \%}}{\text{HCE \%}} = \frac{67\%}{80\%} = 84\%$

84% > 70%, therefore, the plan passes Minimum Coverage by using the Ratio Percentage Test.



Did your plan fail the Ratio Percentage Test?

- Try the Average Benefits Test on page 15. OR
- If the plan is noncontributory, you might consider amending the plan to expand the number of employees benefiting under the plan (including retroactive plan contributions/benefits to the newly eligible employees). To pass this test, the correction must be made by the 15th day of the 10th month following the end of the plan year for which the amendment is being made.

Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Section Two: Minimum Coverage Tests

How to test a plan for Minimum Coverage: Average Benefits Test

If a plan fails the Ratio Percentage Test, you may be able to satisfy the two-prong Average Benefits Test, both prongs of which must be met. Prong 1 is a two-part test that seeks to show that independent of all other plans, the tested plan covers a nondiscriminatory classification of employees; **Prong 2** compares benefits received by NHCEs from all the employer's plans to those received by HCEs.

Example

An institution offers two plans: Plan A for staff covers only NHCEs and therefore, automatically satisfies all nondiscrimination requirements; Plan B for faculty and administration fails the Ratio Percentage Test, so we try the Average Benefits Test.

Prong 1—Nondiscriminatory Classification Test (NCT)

Part 1 of NCT—Reasonable Classification

Determine if the classification of employees who benefit under the plan is reasonable and is based on objective business criteria. Reasonable classifications include job categories or nature of compensation (salaried vs. hourly), but not enumeration of employees by name or similar criteria. If the classification isn't reasonable, the plan fails the Average Benefits Test.

A plan for faculty and administrators is a reasonable classification, so Plan B passes the nondiscriminatory classification test. Proceed directly to Step 2.

If testing rate groups, special rules apply (see [page 21](#)).

Part 2 of NCT—Safe and Unsafe Harbor Tests

Step 1

- Determine the total number of nonexcludable HCEs and NHCEs.
- Determine how many HCEs and how many NHCEs benefit under the plan.

Example

Total employees	325
Excludable employees	– 75
Nonexcludable employees	250

	Nonexcludable employees	Employees benefiting (Plan B)
HCEs	50	49
NHCEs	200	120
Total	250	169

Step 2

- Determine the NHCE Concentration Percentage by dividing the total number of nonexcludable NHCEs by the total number of nonexcludable employees.
- From the table in Appendix G, find the Safe and Unsafe Harbor Percentages that apply given the plan's calculated NHCE Concentration Percentage.

Example

- NHCE Concentration Percentage = $200/250 = 80\%$
- From the table in Appendix G, we obtain the following:
 - Safe Harbor Percentage = 35%
 - Unsafe Harbor Percentage = 25%

Section Two: Minimum Coverage Tests

Step 3

- a. Determine the percentage of NHCEs benefiting under the plan by dividing the number of NHCEs benefiting by the total of nonexcludable NHCEs.
- b. Determine the percentage of HCEs benefiting under the plan by dividing the number of HCEs benefiting by the total nonexcludable HCEs.
- c. Divide the percentage determined in Step 3(a) by the percentage determined in Step 3(b).

Example

- a. $120/200 = 60\%$
- b. $49/50 = 98\%$
- c. $60\%/98\% = 61\%$

Step 4: Safe Harbor Test

If the percentage determined in Step 3(c) equals or exceeds the Safe Harbor percentage (Step 2(b)), the plan is considered to satisfy this requirement of the Average Benefits Test; proceed to Prong 2 on **page 17**. Otherwise, try the Unsafe Harbor test in Step 5.

Example

$61\% > 35\%$; therefore, Prong 1 of the Average Benefits Test is met for Plan B.

If testing a rate group, special rules apply (see **page 24**).

Step 5: Unsafe Harbor Test

If the percentage determined in Step 3(c) equals or exceeds the Unsafe Harbor percentage (Step 2(b)), but is less than the Safe Harbor percentage, the determination of whether or not the plan covers a nondiscriminatory classification is based on facts and circumstances. If you feel that your classification is reasonable and will satisfy the IRS, proceed to Prong 2 on **page 17**.

Example

Because Plan B satisfied the Safe Harbor Test (Step 4), the Unsafe Harbor Test does not need to be applied.

Note: Relevant facts and circumstances include the validity of the business reason for the classification, the percentage of employees benefiting, whether employees in all salary ranges are proportionately covered, how close the plan is to passing the Safe Harbor Test and the margin by which the Average Benefits Percentage Test is passed (see **page 17**).



Did your plan fail the Nondiscriminatory Classification's Safe/Unsafe Harbor test?

You might consider amending the plan to increase the number of non-highly compensated employees benefiting under the plan (including retroactive plan contributions/benefits to the newly eligible employees). To pass this test, the correction must be made by the 15th day of the 10th month following the end of the plan year for which the amendment is being made.

Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Section Two: Minimum Coverage Tests

Prong 2—Average Benefits Percentage Test

Step 1

- a. Sort all nonexcludable employees by HCE or NHCE status.
- b. Calculate a contribution percentage for each employee benefiting under any plan by dividing the employer's contributions during the current plan year by compensation earned during the portion of the plan year during which the employee was eligible for one of the plans.

403(b) Plan Testing

You may aggregate 403(b) and 401(a) plans in this step.

401(a), 403(a) and 401(k) Plan Testing

You may aggregate defined benefit plans in this step, but must exclude 403(b) plans.

Contributory and noncontributory plans are aggregated for this portion of Minimum Coverage Testing only (they're tested separately for the Ratio Percentage and Nondiscriminatory Classification Tests). Only employer contributions are counted when calculating contribution percentages. If the plans you are testing include a defined benefit plan, you will have to cross test the plans (see the definition of cross testing on [page 51](#)).

- c. Calculate the average contribution percentage for HCEs by totaling the contribution percentages (Step 1(b)) and dividing this total by the number of nonexcludable HCEs; do the same for NHCEs. (Note that nonexcludable employees eligible for no plan and nonparticipating employees eligible for a contributory plan must be averaged in as zeros; those eligible for contributory plans at the start of the plan year, but not electing to participate until mid-year would be calculated based on compensation earned during the entire year).

Example (a) (b) (c)

HCE	$\frac{\text{ER Contribution}}{\text{Compensation}} = \text{Contribution Percentage}$
A	$\$21,000 / 150,000 = 14\%$
B	$\$19,600 / 140,000 = 14\%$
L	$\$13,000 / 130,000 = 10\%$
	HCE average = 12.7%
NHCE	$\frac{\text{ER Contribution}}{\text{Compensation}} = \text{Contribution Percentage}$
M	$\$5,760 / 48,000 = 12\%$
N	$\$4,500 / 45,000 = 10\%$
ZZ	$\$2,520 / 28,000 = 9\%$
	NHCE average = 10.3%

Section Two: Minimum Coverage Tests

Step 2

- a. Divide the NHCE average contribution percentage by the HCE average contribution percentage (these percentages were calculated in (Step 1(c)) to get the plan's average benefit percentage.
- b. If the average benefit percentage calculated in (a) equals or exceeds 70%, the plan passes the Average Benefits Percentage Test. If it also passes the first Prong discussed on **pages 15** and **16** above, the plan satisfies Minimum Coverage requirements; proceed with General Nondiscrimination testing. (See **Section 3**).

Example

- a. $\frac{10.3\%}{12.7\%} = 81.1\%$
- b. $81.1\% > 70\%$; therefore, Prong 2 of the Average Benefits Test is met. Because Prong 1 is also met, Plan B passes Minimum Coverage.



Did your plan fail the Average Benefits Percentage Test?

You may want to try cross testing the plan, i.e., “convert” contributions into equivalent benefits if your plan is noncontributory and rerun this test on a benefits basis (see **page 51**).

Also, if at least one of the plans included in the Average Benefits Percentage Test calculation [Step 1(b)] is noncontributory, an adjustment may be made to the employees' contribution percentages to reflect the employer's Social Security contribution, whether or not it is an integrated plan. This increases the complexity of the Average Benefits Test substantially, but is the only way a number of plans will pass the Minimum Coverage Test. (See discussion of Social Security integration on **page 8**.)

Alternatively, you may consider amending the plan to increase contributions for NHCEs. For noncontributory plans, the benefits can be increased for all NHCEs, or just for NHCEs who benefited during the year or only for NHCEs who didn't benefit. For contributory plans, the amendment must grant Qualified Nonelective Contributions (QNECs) to NHCEs who were not eligible for the plan in an amount equal to the matching rate for eligible NHCEs. The amendment must be made by the 15th day of the 10th month following the end of the plan year being corrected. (See definition of QNEC on **page 58**.)

Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Section Three: General Nondiscrimination

Does this test apply to my plan(s)?

Applies to:

All contributory and noncontributory plans

Good to know:

Before testing for General Nondiscrimination, you may want to review:

- The special rules on the plan's definition of compensation (**page 6**)
- The limit on the amount of compensation a plan can take into account when calculating contributions and doing nondiscrimination testing (**page 6**)
- Social Security Integration (**page 8**)
- Credit for related industry service (**page 10**)
- Contributions for former employees (**page 10**)
- Excludable employees (**page 11**)
- If your workforce includes leased employees (**page 12**)

General Nondiscrimination rules require that plans do not discriminate against non-highly compensated employees with respect to contributions and availability of other benefits, rights and features. Also, any plan amendments and plan terminations must not result in discrimination in favor of highly compensated employees.

Who?

All contributory and noncontributory plans. The same "plan" tested under Minimum Coverage must satisfy these General Nondiscrimination requirements.

When?

A plan can be tested (1) quarterly; (2) on the last day of the plan year (taking into account everyone employed on any day during the year); (3) on any single day during the plan year ("snapshot testing", see **page 60**); or (4) if there haven't been any significant changes since the last test date, as seldom as once every three years ("three-year testing", see **page 61**). The ACP (Matching Test) and ADP Test (if the plan is a 401(k)) (**Sections 4 and 5**) must be applied to a contributory plan every year, taking into account everyone employed on any day during the plan year.

Impact?

If your plan fails this test, it could cause plan contributions to be currently taxable to plan participants unless you correct the failure.

Section Three: General Nondiscrimination

How to test your noncontributory plan for General Nondiscrimination

To pass the General Nondiscrimination Test, you must separately look at three aspects of your plan:

- 1 Amount of contributions or benefits
- 2 Availability of optional forms of benefits, rights and features, and
- 3 Plan amendments and plan terminations

Step 1: Amount of contributions

To test whether contributions to a noncontributory plan are nondiscriminatory in amount, you may rely on a safe harbor or perform the General Test.

A. Uniform Allocation Safe Harbor:

If you contribute the same percentage of a nondiscriminatory definition of compensation to the accounts of all employees covered by the plan, you satisfy this design-based safe harbor and can proceed to Step 2 on **page 22**. (A formula integrated with Social Security as described on **page 8** is considered a uniform formula.)

Example

A plan offering a flat contribution of 10% to all employees with contributions based on W-2 compensation would satisfy the Uniform Allocation Safe Harbor. Similarly, the plan would comply if it offered an additional 5.7% (i.e., a total contribution of 15.7%) contribution on compensation over the Social Security Wage Base (SSWB).

B. Uniform Points Safe Harbor:

An age- or service-graded plan can qualify for this safe harbor if contributions are based on the number of “points” credited to each participant and each participant receives the same number of points for each year of age or service. Very few, if any age- or service-graded plans funded with TIAA annuity contracts or mutual funds are designed to qualify for this safe harbor. Stop: If you don’t satisfy a safe harbor, proceed to Step 1(C) “General Test—Rate Group Testing”

Example

A plan offering a flat contribution of \$25 to employees for each “point” with a point awarded for each year of service would qualify for the Uniform Point Safe Harbor. With this type of plan, all eligible employees with the same number of years of service would receive the same amount of contributions regardless of their level of compensation.

If you don’t satisfy a safe harbor, proceed to **Step 1(C)**.

Section Three: General Nondiscrimination

C. General Test—Rate Group Testing:

A plan will pass this test if the rate group¹ for each highly compensated employee (HCE) independently satisfies one of the Minimum Coverage Tests. An HCE's rate group consists of all plan participants (both HCEs and non-highly compensated employees (NHCEs)) who have allocation rates at least as high as that of the HCE being tested.

- 1 Determine allocation rates for each participant by dividing his or her contribution by compensation.
- 2 Determine the rate group for each HCE. Any participant with an allocation rate at least as high as that of an HCE is included in that HCE's rate group. Because you will have as many rate groups as you have HCEs, participants may be included in more than one rate group. However, HCEs with the same allocation rates will have identical rate groups, so only one of them will actually need to be tested.
- 3 Return to the Minimum Coverage Test (**page 14**) and test each rate group as if it were a separate plan using the Special Rules described below.

If all rate groups satisfy Minimum Coverage, your plan satisfies the amount of contributions portion of the General Nondiscrimination Test.

Example

- 1 The first step in conducting the General Test is to calculate an allocation rate for each employee:

Employee	Contribution Compensation	=	Allocation rate
HCE-A	\$19,000/\$190,000	=	10%
HCE-B	\$14,800/\$185,000	=	8%
NHCE-C	\$4,100/\$40,000	=	10.25%
NHCE-D	\$3,000/\$30,000	=	10%
NHCE-E	\$1,800/\$20,000	=	9%
NHCE-F	\$1,360/\$16,000	=	8.5%

- 2 Rate group A includes HCE-A, NHCE-C and NHCE-D. Rate group B includes HCE-A, HCE-B, NHCE-C, NHCE-D, NHCE-E and NHCE-F.
- 3 Special Rules—Applying Minimum Coverage to Rate Groups
 - a. When applying the Nondiscriminatory Classification portion of the Average Benefits Test to a rate group, you don't have to perform the Reasonable Classification part of the test.
 - b. A rate group satisfies part 2 of the Nondiscriminatory Classification Test only if the percentage determined in Step 3(c) (see **page 16**) for the rate group is at least equal to the lesser of:
 - i. The midpoint between the Safe Harbor and Unsafe Harbor percentages applicable to the plan as a whole or
 - ii. The plan's ratio percentage (see **page 14**)

¹ See definition of rate group on **page 58**.



Did your plan fail rate group testing?

If a plan fails the General Nondiscrimination Test's nondiscriminatory availability of amount of contributions requirement, you might consider amending the plan to increase contributions for NHCEs. The plan amendment must be adopted by the 15th day of the 10th month following the end of the plan year being corrected. Alternatively, you may want to try cross testing (see **page 51**).

Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Section Three: General Nondiscrimination

Step 2: Other benefits, rights and features

Optional forms of benefits and other rights and features must be made available on a nondiscriminatory basis.

The term “optional forms of benefits” means any distribution option available under the plan, including early retirement and lump-sum options, as well as standard lifetime annuity payouts.

The term “right or feature” generally means any right or feature of the plan that is available to participants and is of more than insignificant value. Examples include investment options, transfer options and loan provisions.

If a defined contribution and a defined benefit plan are combined to pass the Minimum Coverage Test, the plans must also be combined for purposes of the General Nondiscrimination Test. However, a special rule may be available when testing the availability of certain benefits, rights or features that are not considered “core” benefits and which aren’t uniformly available to all employees eligible under the combined plan.

Example

A cash withdrawal policy made available to one group of employees (faculty) but not to another (support staff) is an “optional form of benefit” that would have to be available to a group of employees that does not discriminate in favor of HCEs.

In order to show that a plan’s benefits, rights and features are available on a nondiscriminatory basis, they must pass both a “Current Availability Test” and an “Effective Availability Test.”

- a. **Current Availability Test.** This test is satisfied if each benefit, right and feature is currently available to a group of employees that satisfies the Ratio Percentage Minimum Coverage Test (**page 14**) or the first prong of the Average Benefits Test (**page 15**). In determining current availability, you may disregard conditions requiring termination of employment, death, change in family status, disability or hardship. Furthermore, when testing the availability of an optional form of benefit, you can also disregard requirements based on years of service and age unless they must be satisfied within a limited period of time, as in a window plan (e.g., a plan feature that is only available to employees during a window period such as between ages 60 and 65).

Example

A cash withdrawal offering 25% cash to all employees with 20 years of service at the later of retirement or age 65 would be considered currently available to all employees because requirements based on years of service or age are disregarded.

- b. **Effective Availability Test.** This test is satisfied if each benefit, right and feature is in fact available to a group of employees that doesn’t substantially favor HCEs in light of all facts and circumstances. If all benefits, rights and features are currently and effectively available, proceed to Step 3 (e.g., a plan feature that is only available to employees during a window period such as between ages 60 and 65).

Note: The cash withdrawal policy described in the example above may not be deemed effectively available if demographically most current NHCEs couldn’t attain 20 years of service by age 65 and most employees can be expected to retire by age 65.



Did your plan fail the test for other benefits, rights, and features?

If any benefit, right or feature doesn’t satisfy the availability requirement, your plan fails. However, the plan can be amended to correct a failure of the current availability requirement, provided the amendment isn’t part of a series of amendments to correct repeated failures and the amendment remains in effect through the end of the first plan year beginning after the date of the amendment. The corrective plan amendment must be implemented by the 15th day of the 10th month after the close of the plan year.

The amendment must expand availability for the benefit, right or feature on a prospective basis. Alternatively, the amendment can correct failure by eliminating a benefit, right or feature for all employees, unless the benefit is a “protected” benefit under the IRC §411(d)(6) “anti-cutback rule,” e.g., an early retirement, lump-sum or other payout option. Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Section Three: General Nondiscrimination

Step 3: Plan amendments and terminations

Review your plan design with respect to the timing of any plan amendments. The effect of plan amendments must be nondiscriminatory. For this purpose, plan amendments include plan establishment or termination; any change in benefits, rights or features; change in contribution rates; or grants of credit for prior service. Whether a plan meets this test depends on facts and circumstances. If the timing of the amendments has a discriminatory impact, you might need to make additional changes to the plan.

Step 4

If you met Steps 1, 2 and 3, you satisfy the General Nondiscrimination requirement. If you have also satisfied Minimum Coverage (**Section 2**) requirements, you have completed nondiscrimination testing for your plan. Congratulations! See you next year, unless you qualify for three-year testing. If you failed to satisfy one of the requirements, you might consider an amendment to your plan to avoid possible disqualification.

NOTE: Please consult with your legal counsel to ensure you have met the applicable nondiscrimination requirements for your plan and/or before amending your plan.

If you intend to rely on three-year testing, make sure to confirm with your legal counsel that you qualify for such method.

Section Three: General Nondiscrimination

How to test your voluntary contributory plan for General Nondiscrimination

As with noncontributory plans, for a voluntary contributory plan to pass the General Nondiscrimination Test, you must separately look at three aspects of your plan: (1) amount of contributions, (2) other benefits, rights and features, and (3) plan amendments and plan terminations.

Different Requirements for 403(b) and 401(k) Plans

Voluntary contributory IRC section 403(b) plans with employer contributions must satisfy the ACP Test (unless the plan sponsor is a public employer and, thus, exempt from ERISA), while IRC section 401(k) plans with employers contributions must satisfy both the Actual Deferral Percentage (ADP) and ACP Tests. Both types of plans can, alternatively, satisfy a safe harbor plan design. Voluntary contributory 403(b) plans are not subject to the ADP Test but are subject to the universal availability requirement addressed on [page 41](#).

Step 1: Contributions

To pass General Nondiscrimination with regard to amount of contributions, a contributory 401(k) plan must satisfy the ACP (Matching) Test detailed in [Section 4](#) and the ADP Test detailed in [Section 5](#) or one of the Design-Based Safe Harbors detailed in [Section 6](#) as an alternative to the ACP and ADP Tests.

Other contributory plan types must satisfy the ACP Test detailed in [Section 4](#) or one of the Design-based Safe Harbors detailed in [Section 6](#) as an alternative to the ACP Test.

Please note that the ACP test does not apply to mandatory contributory plans and those using irrevocable salary reduction agreements. It also does not apply to noncontributory plans (which is not necessarily relevant in this section on testing contributory plans, but is noted nonetheless).

Step 2: Other benefits, rights and features

Optional forms of benefits and other rights and features must be made available on a nondiscriminatory basis. The term “optional forms of benefits” means any type of distribution option that is available under the plan. Early retirement options, lump-sum payout options as well as standard lifetime annuity payouts are all types of optional forms of benefits that must be made available on a nondiscriminatory basis.

Example

A cash withdrawal policy made available to one group of employees (faculty) but not to another (support staff) would have to be available to a group of employees which does not discriminate in favor of HCEs.

The term “right or feature” generally means any right or feature of the plan that is available to participants and is of more than insignificant value. Examples include age or service grades, investment options, transfer options and loan provisions.

Until 2009, multiple rates of matching contributions in voluntary contributory 403(b) plans were not considered separate rights or features that needed to be tested for nondiscriminatory availability.

In 2009, the final 403(b) regulations repealed the good faith testing methods for nondiscrimination testing of 403(b) plans that had made this possible since 1989 through Notice 89-23.

Starting in 2009, the right to each rate of match under a 403(b) plan is considered a plan right that must be tested for nondiscriminatory availability. So, age or service-graded-matching plans must now test each grade for nondiscriminatory availability, even if the plan passes the Matching Test. 401(k) plans had always been required to do this.

In order to show that a plan’s benefits, rights and features are available on a nondiscriminatory basis, they must pass both a “Current Availability Test” and an “Effective Availability Test.”

- a. **Current Availability Test.** This test is satisfied if each benefit, right and feature is currently available to a group of employees that satisfies the Ratio Percentage Test ([page 14](#)) or the first prong of the Average Benefits Test ([page 15](#)). In determining current availability, you may disregard conditions requiring termination of employment, death, change in family status, disability or hardship. When testing the availability of an optional form of benefit, you can also disregard requirements based on years of service and age unless they must be satisfied within a limited period of time, as in a window plan.

Section Three: General Nondiscrimination

Step 2 (continued)

Example

A cash withdrawal policy offering 25% cash to all employees with 20 years of service at the later of retirement or age 65 would be considered currently available to all employees because requirements based on years of service or age are disregarded.

- b. Effective Availability Test. This test is satisfied if each benefit, right and feature is in fact available to a group of employees that doesn't substantially favor HCEs in light of all facts and circumstances. If all benefits, rights and features are currently and effectively available, proceed to Step 3.

Note: The cash withdrawal policy described in the example in the left column may not be deemed effectively available if demographically current NHCEs couldn't attain 20 years of service by age 65 and most employees can be expected to retire by age 65.



Did your plan fail the Effective Availability Test?

Your plan fails if any benefit, right or feature doesn't satisfy the current availability requirement. However, the plan can be amended to correct a failure of the current availability requirement, provided the amendment isn't part of a series of amendments to correct repeated failures and the amendment remains in effect through the end of the first plan year beginning after the date of the amendment.

The corrective plan amendment must be implemented by the 15th day of the 10th month after the close of the plan year. The amendment need only expand availability of the benefit, right or feature on a prospective basis.

Alternatively, the amendment can correct failure by eliminating a benefit, right or feature for all employees unless the benefit is a "protected" benefit under IRC §411(d)(6) (the "anti-cutback rule"), e.g., an early retirement, lump-sum or other payout option.

Step 3: Plan amendments and plan terminations

Review your plan design with respect to the timing of any plan amendments. The effect of plan amendments must be nondiscriminatory. For this purpose, plan amendments include plan establishment or plan termination; any change in benefits, rights or features; change in contribution rates; or grants of credit for prior service. Whether or not a plan meets this test depends on facts and circumstances. If the timing of the amendments has a discriminatory impact on NHCEs, you might consider an amendment to your plan.

Before amending your plan, you should consult with your legal counsel to ensure that you continue to operate your plan in accordance with its terms and the applicable guidance.

Step 4

If you met Steps 1, 2 and 3, you satisfy the General Nondiscrimination requirement. If you have also satisfied Minimum Coverage (**Section 2**) requirements, you have completed nondiscrimination testing for your plan. Congratulations! See you next year. If you fail to meet the requirements, you must take other corrective action such as amending your plan, refunding excess deferrals and/or aggregate contributions to HCEs.

Make sure to consult with your legal counsel to ensure you have met the required nondiscrimination requirements. If corrective action is necessary, make sure you consult with your counsel to utilize the appropriate correction for your plan.

Section Four: ACP (Matching) Test

? Does this test apply to my plan(s)?

Applies to:

All voluntary contributory plans, except if:

- The plan qualifies for one of the design-based safe harbors
- As a condition of employment, employee contributions are mandatory
- Irrevocable salary deferral agreements are used.

Does not apply to:

- Noncontributory plans ([page 51](#))
- Mandatory contributory plans ([page 61](#))
- Plans using irrevocable salary deferral agreements ([page 56](#))

Even though a plan satisfies all requirements relating to the benefits it offers, if employee contributions are required as a condition of receiving employer “matching” contributions or if the plan accepts after-tax employee contributions, the Actual Contribution Percentage (ACP) Test (also known as the Matching Test) must be satisfied (in addition to the Actual Deferral Percentage Test for qualified 401(a) plans with a 401(k) feature). This ACP Test compares matching and after-tax employee contributions allocated to highly compensated employees to those allocated to non-highly compensated employees.

Who?

All voluntary contributory plans (and plans that accept after-tax employee contributions) are subject to the ACP Test. Among qualified plans, the contributory ones are typically 401(k) plans. But qualified plans that accept after-tax employee contributions or to which employer contributions are made only if employees make voluntary contributions to a 403(b) plan are also subject to the ACP Test. In addition, voluntary contributory 403(b) plans are also subject to the ACP Test. If all employee contributions to the qualified plan (or a 403(b) plan) are mandatory as a condition of employment (mandatory contributory) or are made pursuant to irrevocable salary deferral agreements, made on or before the employee becomes eligible to participate in any of the employer’s plans, the plan is not subject to the ACP Test, even though the employer matches those contributions. Union employees must generally be tested separately (see Appendix D on [page 62](#)).

When?

Contributory retirement plans must satisfy this test at the end of each plan year, taking into account everyone employed on any day during the plan year, unless they satisfy one of the Design-Based safe harbors (see [Section 6](#)).

Impact?

The ACP Test seeks to assure that in requiring employee contributions as a condition of receiving employer contributions (but not as a condition of employment), a plan does not discriminate in favor of highly compensated employees. If certain limits are exceeded, correction must be made or the plan risks disqualification.

How to perform the ACP (Matching) Test:

Step 1

Calculate the Actual Contribution Ratio (ACR) for each eligible HCE and NHCE by dividing employer-matching contributions (ER)² plus employee after-tax (deduction) contributions (DEDUC) by compensation (COMP):

$$\text{ACR} = \frac{\text{ER} + \text{DEDUC}}{\text{COMP}}$$

If an employee becomes eligible for the employer match during the plan year, you can include only compensation earned after he or she becomes eligible, as long as the same procedure is used for all newly eligible employees. (See [page 6](#) for a discussion of using the plan definition of compensation for testing purposes.)

ACRs for NHCEs can be determined using either the Current Year Testing Method or the Prior Year Testing Method. The testing method used must be set forth in the plan document.

Current year data must be used for calculating contribution percentages for HCEs regardless of whether the Current or Prior Year Testing Method is used. If any HCE participates in more than one contributory plan to which this test applies, all employee and employer-matching contributions for the HCE must be aggregated for purposes of this ACP Test.

- **Current Year Testing Method.** If the plan sponsor selects this method, contribution percentages for both HCEs and NHCEs are calculated based on salary and contribution data for the plan year for which the ACP Test is being conducted.
- **Prior Year Testing Method.** If the plan sponsor selects this method, contribution percentages for NHCEs are calculated based on salary and contribution data for the plan year prior to the year for which the ACP Test is being conducted. HCE contribution percentages are calculated based on salary and contribution data for the plan year being tested.

Classify as HCEs only those employees who received compensation over the highly compensated limit in the prior year. If more than 20% of employees received compensation over the dollar limit, HCEs can be limited to the top-paid 20%.

If NHCE contribution percentages are calculated using the Current Year Testing Method:

- 1 Include only NHCEs eligible during the year being tested.
- 2 Treat any employee who was not an HCE in the prior year as an NHCE.

If NHCE contribution percentages are calculated using the Prior Year Testing Method, you will need data from the prior year. (See Step 2 on [page 28](#) for instructions for calculating the NHCE ACP.) Always calculate the current year NHCE ACP, even if you are using the Prior Year Testing Method, since you will need this information for next year's testing.

² Qualified Nonelective Contributions (QNECs) may be voluntarily included in the calculation as employer contributions. But QNECs that were used when performing the ADP Test may not be included when performing the ACP Test (see definition of QNEC on [page 58](#)).

Section Four: ACP (Matching) Test

Step 2

Calculate the average contribution percentage (ACP) for eligible HCEs and NHCEs by dividing the sum of the Actual Contribution Ratios (ACRs) of the HCEs (or NHCEs) by the number of eligible HCEs (or NHCEs).

Example

Institution XYZ has a contributory 401(k) retirement plan. Employees who elect to participate in the plan contribute 5% of compensation (either elective deferral or salary deduction) and the employer makes matching contributions equal to 10% of the employee's compensation. The plan definition of compensation excludes bonuses.

Employee	Prior Plan Year		Current Plan Year	
	HC/NHC	ACR	HC/NHC	ACR
A	HC	10%	HC	9.26%
B	HC	10%	HC	9.52%
C	HC	10%	HC	10%
D	HC	10%	HC	10%
E	HC	10%	HC	10%
F	NHC	10%	HC	10%
G	NHC	10%	NHC	10%
H	NHC	10%	NHC	10%
I	NHC	5%	NHC	10%
J	n/a	n/a	NHC	10%
K	NHC	0%	NHC	0%
L	NHC	10%	NHC	10%
M	NHC	0%	n/a	n/a
N	NHC	15%	NHC	15%

Based on the data above, if XYZ uses:

- Prior year data to calculate contribution percentages for NHCEs when conducting the ACP Test for the current plan year, then employees F, G, H, I, K, L, M and N will be the only ones used in calculating ACR for the NHCEs. That's because they were the NHCEs who were eligible for the plan in the prior year. Also, note that:
 - Employee I has a 5% contribution rate because, although he was eligible for the entire year, he became a participant in midyear.
 - Employee J is disregarded because he did not become eligible for the plan until the current year.
 - Employee L has a 10% ACR in spite of having prior year compensation of \$35,000 and contributions of \$1,200 because she only received compensation of \$12,000 for the portion of prior year after she became eligible for the plan.
 - Employee N has a contribution rate of 15% because he made his contributions in the form of salary deductions [salary deductions are counted for purposes of the ACP Test, but elective deferrals (pretax or Roth) are not].
 - Employees K and M are included in the calculation with ACRs of 0% since they were eligible but not participating.

The NHCE ACP is 7.5% [(10% + 10% + 10% + 5% + 0 + 10% + 0 + 15%) divided by 8].

- Current year data to calculate contribution percentages for NHCEs, then employees G, H, I, J, K, L and N, will be the only ones used in calculating ACR for the NHCEs. That's because they were the NHCEs who were eligible for the plan in the current year. Also, note that:
 - Employee M is disregarded when current year data is used because he separated from service during the prior year, and therefore, was not eligible for the plan in the current year.

Section Four: ACP (Matching) Test

- Employee N still has a contribution rate of 15% because he also made his contributions in the form of salary deductions in the current year.
- Employee K is included in the calculation with an ACR of 0% since he was eligible but not participating.

The NHCE ACP is 9.29% [(10% + 10% + 10% + 10% + 0 + 10% + 15%) divided by 7].

Institution XYZ will probably treat Employees A, B, C, D, E and F as HCEs when testing for the current plan year since they all had compensation that exceeded the HCE threshold for the previous year and all were eligible for its contributory retirement plan in the current year. (Note that if prior year testing is used, F will be included as both an HCE and as an NHCE for the current plan year. If more than 20% of Institution XYZ's employees had compensation exceeding the standard threshold amount for determining HCE status, then the Institution could use the Top Paid Group election (i.e., the top 20%) for its HCE determination. In this case, only employees A, B and C would be classified as HCEs in the current year. This election would help XYZ pass the test since employees D, E and F with 10% contribution percentages would be moved from the HCE to the NHCE category thereby lowering the ACP for the HCEs and raising the ACP for the NHCEs.

Employees A and B have ACRs of less than 10% for the current plan year because they both received bonuses, which the plan does not take into account for purposes of calculating contributions, but which the 401(m) regulations require to be included in compensation for purposes of calculating ACRs. The HCE ACP is 9.80% [(9.26% + 9.52% + 10% + 10% + 10% + 10%) divided by 6] if the plan uses the standard threshold amount for determining HCE status. The HCE ACP will only be 9.59% [(9.26% + 9.52% + 10%) divided by 3] if only the top-paid 20% are treated as HCEs.

Step 3

Review the NHCE average contribution percentage (NHCE-ACP):

- Where the NHCE ACP ≤ 2%** Multiply the NHCE ACP by 2. If the HCE ACP for the current year is not more than this product, you satisfy the ACP Test. Otherwise, go to Step 4.
- Where the NHCE ACP is between 2% and 8%** Add 2% to the NHCE ACP. If the HCE ACP for the current year is not more than this sum, you satisfy the ACP Test. Otherwise, go to Step 4.
- Where the NHCE ACP > 8%** Multiply the NHCE ACP by 1.25. If the HCE ACP for the current year is not more than this product, you satisfy the ACP Test. Otherwise, go to Step 4.

If you don't satisfy the ACP Test using your current testing method, you may want to consider using the alternative testing method for subsequent years. Once you have elected to use the Current Year Method, however, you cannot switch to using the Prior Year Method unless you used the Current Year Method for at least five years. There is no similar limit on switching from the Prior Year Method to the Current Year Method. Your plan document must specify which of the two testing methods is to be used. If you change testing methods, plan documents must be amended.

As noted on **page 39**:

- If XYZ elects to use the Current Year Testing Method, the NHCE ACP is 9.29. Since 9.29 is more than 8%, the plan passes if the HCE ACP is not more than 11.61% (1.25 times 9.29%). The HCE ACP is 9.80%, so the plan passes the ACP Test using the Current Year Testing Method. The plan should pass by a wider margin if only the top-paid 20% of employees (A, B and C) were treated as HCEs.
- If Institution XYZ uses the Prior Year Testing Method to calculate the ACRs for its NHCEs, the NHCE ACP will be 7.50%. Since 7.50% is between 2% and 8%, the plan passes if the HCE ACP is not more than 9.50% (7.50% + 2%). The HCE ACP is 9.80%, however, so the plan fails the ACP Test. If XYZ elected to treat only the top 20% as HCEs, the NHCE ACP will be 8% and the plan will pass since the HCE ACP will only be 9.59% which is less than the permissible 10% (8% + 2%).

Using the Current Year Testing Method may help you to pass the ACP Test in some years, but it can also work against you depending upon changes in demographics and participation from year to year. Many plans funded with TIAA annuities and mutual funds have chosen to use the Current Year Testing Method in large part because it avoids the need for using payroll data from different years when calculating contribution percentages for HCEs and NHCEs.

Section Four: ACP (Matching) Test



Did your plan fail the ACP (Matching) Test?

If you don't satisfy the ACP Test, you can correct the problem by adding qualified nonelective contributions (QNECs) for NHCEs or by refunding excess contributions to HCEs to the extent necessary to pass the ACP Test. The QNECs must be made by the end of the year following the one to which it relates and must not have already been used to correct failure of the ADP Test (for contributory 401(k) plans). If you test during the plan year using estimated plan data and it appears that the test will not be passed, contributions for the HCEs can be reduced by stopping contributions before the end of the plan year or by capping compensation used to calculate contributions.

If a plan without a waiting period or age or service requirement fails the ACP test because many young and/or newly hired employees do not participate in the plan even though they are eligible, it may meet matching test requirements by testing as if there were two plans:

- 1 A "plan" covering only employees who are under age 21 and have less than one year of service which can pass the nondiscrimination tests after excluding all employees who have met these age and service requirements, and
- 2 A "plan" covering employees who have met these requirements that can pass the nondiscrimination tests excluding all employees who have not met the requirements. In most cases, both plans will meet nondiscrimination requirements and, if all HCEs have satisfied the age 21 and one-year-of-service requirements, the "plan" covering only employees who have not met these requirements will automatically meet all nondiscrimination requirements without testing.

To qualify as QNECs that can be counted when conducting the ACP Test, employer contributions cannot be:

- Matching contributions that are only made for employees that make elective contributions to the plan,
- Have already been included in the calculations for the ADP Test (for contributory 401(k) plans),
- Subject to delayed vesting,
- Available to employees as a cash payment as an alternative to a plan contribution,
- Eligible for withdrawal before earliest of age 59½, separation from service, disability, a qualified distribution to a reservist or death.

QNECs must also independently meet General Nondiscrimination requirements.

QNECs in excess of the greater of 5% of compensation or two times the plan's representative contribution rate may be subject to additional complicated regulatory requirements. Plan sponsors should discuss this carefully with competent legal counsel.

If the Prior Year Testing Method is used, QNECs for NHCEs must be made by the end of the testing year because the ACP for NHCEs is based on prior year data. If the Current Year Testing Method is used, QNECs must be made by the end of the year following the year being tested.

Plan sponsors using the Prior Year Testing Method that are considering the use of QNECs should perform interim testing during the course of the plan year using estimated plan data in order to estimate the amount of QNECs that will be needed in order to ensure that the plan will meet ACP Test requirements.

Section Five: Actual Deferral Percentage (ADP) Test

Applies to:

401(k) plans

Does not apply to:

- Noncontributory plans ([page 51](#))
- Mandatory contributory plans ([page 61](#))
- Those using irrevocable salary deferral agreements ([page 56](#))
- 403(b) plans

Good to know:

ADP requirements can also be satisfied automatically without testing if the plan satisfies the requirements of a safe harbor ([Section 6](#))

Even though a qualified plan with a 401(k) feature satisfies all requirements relating to the benefits it offers, if the plan permits employee elective deferrals (pretax or Roth contributions), the Actual Deferral Percentage (ADP) Test must also be satisfied. This ADP Test compares elective deferrals made by highly compensated employees to those made by non-highly compensated employees.

Who?

401(k) plans that accept employee elective deferrals (pretax or Roth contributions) are generally subject to the ADP Test. If all employee contributions are mandatory as a condition of employment (mandatory contributory) or are made pursuant to irrevocable salary deferral agreements, made on or before the employee becomes eligible to participate in any of the employer's plans, the plan is not subject to the ADP Test. Union employees must generally be tested separately (see [Appendix D on page 62](#)). The ADP Test does not apply to elective deferrals made to 403(b) plans.

When?

401(k) plans that accept elective deferrals, must satisfy this test at the end of each plan year, taking into account everyone employed on any day during the plan year, unless they satisfy one of the Design-Based Safe Harbors (see [Section 6](#)).

Impact?

The ADP Test seeks to assure that elective deferrals made by highly compensated employees are not unduly high in comparison to those made by non-highly compensated employees. If certain limits are exceeded, correction must be made or the plan risks disqualification.

Section Five: Actual Deferral Percentage (ADP) Test

How to perform the ADP Test

Step 1

Calculate the Actual Deferral Ratio (ADR) for each eligible HCE and NHCE by dividing employee elective deferral contributions (EE)⁴ by compensation (COMP):

$$\text{ADR} = \frac{\text{EE}}{\text{COMP}}$$

If an employee becomes eligible to make elective deferrals during the plan year, you can include only compensation earned after he or she becomes eligible, as long as the same procedure is used for all newly eligible employees. (See **page 6** for a discussion of using the plan definition of compensation for testing purposes.)

ADRs for NHCEs can be determined using either the Current Year Testing Method or the Prior Year Testing Method. The testing method used must be set forth in the plan document.

Current year data must be used for calculating deferral percentages for HCEs regardless of whether the Current or Prior Year Testing Method is used. If any HCE participates in more than one plan to which this test applies, all of the HCE elective deferrals must be aggregated for purposes of this ADP Test.

- **Current Year Testing Method.** If the plan sponsor selects this method, deferral percentages for both HCEs and NHCEs are calculated based on salary and contribution data for the plan year for which the ADP Test is being conducted.
- **Prior Year Testing Method.** If the plan sponsor selects this method, deferral percentages for NHCEs are calculated based on salary and contribution data for the plan year prior to the year for which the ADP Test is being conducted. HCE deferral percentages are calculated based on salary and contribution data for the plan year being tested.

Classify as HCEs only those employees who received compensation over the highly compensated limit in the prior year. If more than 20% of employees received compensation over the dollar limit, HCEs can be limited to the top-paid 20% if the election is specified in the plan document.

If NHCE deferral percentages are calculated using the Current Year Testing Method:

- 1 Include only NHCEs eligible during the year being tested
- 2 Treat any employee who was not an HCE in the prior year as an NHCE

If NHCE deferral percentages are calculated using the Prior Year Testing Method, you will need data from the prior year. (See Step 2 on **page 33** for instructions for calculating the NHCE ADP.) Always calculate the current year NHCE ADP, even if you are using the Prior Year Testing Method, since you will need this information for next year's testing.

⁴ Elective deferrals include both pretax and Roth contributions. Qualified Nonelective Contributions (QNECs) may be voluntarily included in the calculation along with employee elective deferrals (see definition of QNEC on **page 58**. But any QNEC included in ADP calculations cannot be used again in ACP calculations.)

*Compensation must be limited to amounts that meet the requirements of IRC Section 415.

Section Five: Actual Deferral Percentage (ADP) Test

Step 2

Calculate the average deferral percentage (ADP) for eligible HCEs and NHCEs by dividing the sum of the Actual Deferral Ratios (ADRs) of the HCEs (or NHCEs) by the number of eligible HCEs (or NHCEs).

Example

Institution XYZ has a 401(k) retirement plan. Employees who elect to participate in the plan contribute 5% of compensation (pretax, Roth or after-tax contributions). The plan definition of compensation excludes bonuses.

Employee	Prior Plan Year		Current Plan Year	
	HC/NHC	ADR	HC/NHC	ADR
A	HC	10%	HC	9.26%
B	HC	10%	HC	9.52%
C	HC	10%	HC	10%
D	HC	10%	HC	10%
E	HC	10%	HC	10%
F	NHC	10%	HC	10%
G	NHC	10%	NHC	10%
H	NHC	10%	NHC	10%
I	NHC	5%	NHC	10%
J	n/a	n/a	NHC	10%
K	NHC	0%	NHC	0%
L	NHC	10%	NHC	10%
M	NHC	0%	n/a	n/a
N	NHC	0%	NHC	0%

Based on the data above, if XYZ uses:

- Prior year data to calculate deferral percentages for NHCEs when conducting the ADP Test for the current plan year, then employees F, G, H, I, K, L, M and N will be the only ones used in calculating ADR for the NHCEs. That's because they were the NHCEs who were eligible for the plan in the prior year. Also, note that:
 - Employee I has a 5% deferral rate because, although he was eligible for the entire year, he became a participant in midyear.
 - Employee J is disregarded because he did not become eligible for the plan until the current year.
 - Employee L has a 10% ADR in spite of having prior year compensation of \$35,000 and contributions of \$1,200 because she only received compensation of \$12,000 for the portion of the prior year after she became eligible for the plan.
 - Employee N has a deferral rate of 0% because he made his contributions in the form of salary deductions [salary deductions are NOT counted for purposes of the ADP Test, but elective deferrals (pretax or Roth) are].
 - Employees K and M are included in the calculation with ADRs of 0% since they were eligible but not participating. The NHCE ADP is 5.62% [(10% + 10% + 10% + 5% + 0 + 10% + 0 + 0) divided by 8].
- Current year data to calculate deferral percentages for HCEs, then employees G, H, I, J, K, L and N, will be the only ones used in calculating ADR for the NHCEs. That's because they were the NHCEs who were eligible for the plan in the current year. Also, note that:
 - Employee M is disregarded when current year data is used because he separated from service during the prior year, and therefore, was not eligible for the plan in the current year.

Section Five: Actual Deferral Percentage (ADP) Test

- Employee N still has a contribution rate of 0% because he also made his contributions in the form of salary deductions in the current year.
- Employee K is included in the calculation with an ADR of 0% since he was eligible but not participating.

The NHCE ADP is 7.14% [(10% + 10% + 10% + 10% + 0 + 10% + 0) divided by 7].

Institution XYZ will probably treat Employees A, B, C, D, E and F as HCEs when testing for the current plan year since they all had compensation that exceeded the HCE threshold for the previous year, and all were eligible for its 401(k) retirement plan in the current year. (Note that if prior year testing is used, F will be included as both an HCE and as an NHCE for the current plan year. If more than 20% of Institution XYZ's employees had compensation the standard threshold amount for determining HCE status, then the Institution could use the Top Paid Group election (i.e., the top 20%) for its HCE determination. In this case, only employees A, B and C would be classified as HCEs in the current year. This election would help XYZ pass the test since employees D, E and F with 10% deferral percentages would be moved from the HCE to the NHCE category, thereby lowering the ADP for the HCEs and raising the ADP for the NHCEs to 8.0% if the Current Year Testing Method is used and to 6.50% if the Prior Year Testing Method is used.

Employees A and B have ADRs of less than 10% for the current plan year because they both received bonuses, which the plan does not take into account for purposes of calculating contributions, but which the 401(k) regulations require to be included in compensation for purposes of calculating ADRs. The HCE ADP is 9.80% [(9.26% + 9.52% + 10% + 10% + 10% + 10%) divided by 6] if the plan uses the standard threshold amount for determining HCE status. The HCE ADP will only be 9.59% [(9.26% + 9.52% + 10%) divided by 3] if only the top-paid 20% are treated as HCEs.

Step 3

Review the NHCE average deferral percentage (NHCE-ADP):

- Where the NHCE ADP \leq 2%** Multiply the NHCE ADP by 2. If the HCE ADP for the current year is not more than this product, you satisfy the ADP Test. Otherwise, go to Step 4.
- Where the NHCE ADP is between 2% and 8%** Add 2% to the NHCE ADP. If the HCE ADP for the current year is not more than this sum, you satisfy the ADP Test. Otherwise, go to Step 4.
- Where the NHCE ADP $>$ 8%** Multiply the NHCE ADP by 1.25. If the HCE ADP for the current year is not more than this product, you satisfy the ADP Test. Otherwise, go to Step 4.

If you don't satisfy the ADP Test using your current testing method, you may want to consider using the alternative testing method for subsequent years. Once you have elected to use the Current Year Method, however, you cannot switch to using the Prior Year Method unless you used the Current Year Method for at least five years. There is no similar limit on switching from the Prior Year Method to the Current Year Method. Your plan document must specify which of the two testing methods is to be used. If you change testing methods, plan documents must be amended.

As noted on [page 34](#):

- If XYZ elects to use the Current Year Testing Method, the NHCE ADP is 7.14. Since 7.14 is more than 2% but less than 8%, the plan passes if the HCE ADP is not more than 9.14% (7.14% + 2%). The HCE ADP is 9.80%, so the plan fails the ADP Test using the Current Year Testing Method. If XYZ elected to treat only the top 20% as HCEs, the NHCE ADP will be 8% and the plan will pass since the HCE ADP will only be 9.59% which is less than the permissible 10% (8% + 2%).
- If Institution XYZ uses the Prior Year Testing Method to calculate the ADRs for its NHCEs, the NHCE ADP will be 5.62%. Since 5.62% is between 2% and 8%, the plan passes if the HCE ADP is not more than 7.62% (5.62% + 2%). The HCE ADP is 9.8%, however, so the plan fails the ADP Test. The plan would still fail, but by a narrower margin if only the top-paid 20% of employees (A, B and C) were treated as HCEs.

Using the Current Year Testing Method may help you to pass the ADP Test in some years, but it can also work against you depending upon changes in demographics and participation from year-to-year. Many plans funded with TIAA-CREF annuities and mutual funds have chosen to use the Current Year Testing Method in large part because it avoids the need for using payroll data from different years when calculating percentages for HCEs and NHCEs.

Section Five: Actual Deferral Percentage (ADP) Test



Did your plan fail the ADP (Actual Deferral Percentage) Test?

If you don't satisfy the ADP Test, you can correct the problem by adding qualified nonelective contributions (QNECs) for NHCEs or by refunding excess deferrals to HCEs to the extent necessary to pass the ADP Test. In addition, under certain circumstances qualified matching contributions (QMACs) made for NHCEs may be taken into account for purposes of satisfying the ADP Test. The QNECs and QMACs must be made by the end of the year following the one to which it relates. If you test during the plan year using estimated plan data and it appears that the test will not be passed, the HCEs' deferrals can be reduced by stopping them before the end of the plan year or by capping compensation used to calculate deferrals.

If a plan without a waiting period or age or service requirement fails the ADP Test because many young and/or newly hired employees do not participate in the plan even though they are eligible, it may meet ADP Test requirements by testing as if there were two plans:

- 1 A "plan" covering only employees who are under age 21 and have less than one year of service which can pass the nondiscrimination tests after excluding all employees who have met these age and service requirements, and
- 2 A "plan" covering employees who have met these requirements that can pass the nondiscrimination tests excluding all employees who have not met the requirements.

In most cases, both plans will meet nondiscrimination requirements and, if all HCEs have satisfied the age 21 and one-year-of-service requirements, the "plan" covering only employees who have not met these requirements will automatically meet all nondiscrimination requirements without testing.

To qualify as QNECs that can be counted when conducting the ADP Test, employer contributions cannot be:

- Matching contributions that are only made for employees that make elective contributions to the plan,
- Subject to delayed vesting,
- Available to employees as a cash payment as an alternative to a plan contribution,
- Eligible for withdrawal before earliest of age 59½, separation from service, disability, qualified distribution to a reservist or death.

QNECs must also independently meet General Nondiscrimination requirements.

To qualify as QMACs that can be counted when conducting the ADP Test, contributions cannot be:

- Subject to delayed vesting;
- Available to employees as a cash payment as an alternative to a plan contribution; or
- Eligible for withdrawal before the earliest of age 59½, separation from service, disability, a qualified distribution to a reservist or death.

QNECs and QMACs in excess of the greater of 5% of compensation or two times the plan's representative contribution rate are generally subject to additional complicated regulatory requirements.

If the Prior Year Testing Method is used, QNECs or QMACs for NHCEs must be made by the end of the testing year because the ADP for NHCEs is based on prior year data. If the Current Year Testing Method is used, QNECs or QMACs must be made by the end of the year following the year being tested.

Plan sponsors using the Prior Year Testing Method that are considering the use of QNECs or QMACs should perform interim testing during the course of the plan year using estimated plan data in order to estimate the amount of QNECs or QMACs that will be needed in order to ensure that the plan will meet ADP Test requirements.

Note: QNECs that are included when performing the ADP Test cannot also be used when performing the ACP Test. If a plan fails both tests and wants to correct by using QNECs, the QNECs will need to be large enough to enable the plan to satisfy both ACP and ADP requirements. If you chose to correct failure of the ADP Test by refunding excess deferrals to HCEs, be sure to remember that any employer-matching contributions allocable to the refunded deferrals must be forfeited by the affected HCEs. In this case, be sure to take into account that any forfeited matching contributions for HCEs will not need to be counted when performing the ACP Test.

Section Six: Design-Based Safe Harbors

Applies to:

- Plans subject to the ADP and/or ACP Tests

Does not apply to:

Noncontributory plans

Good to know:

Plans can satisfy requirements of the ADP and ACP Test by meeting safe harbor requirements

As noted earlier, 403(b) plans (that accept after-tax employee contributions and/or provide matching employer contributions) and 401(k) plans are subject to the ADP and/or the ACP (Matching) Tests.

Fortunately, there is an alternative method for many of these plans to meet these nondiscrimination requirements without testing. Plans that satisfy the requirements of Safe Harbors are deemed to automatically meet all the requirements of the ADP and ACP Tests without having to actually conduct the tests if they do not allow after-tax employee contributions.

Who?

Design-Based Safe Harbors are available to all plans subject to the ADP and/or ACP Tests. And additional safe harbors are available in plan years after December 31, 2007, to plans that adopt automatic enrollment features for their contributory plans.

When?

These safe harbors must generally be satisfied on each day during the plan year.

Impact?

Plans which satisfy these safe harbors are deemed to meet all requirements of the ADP and ACP Tests with regard to employee elective deferrals and employer-matching contributions. Even though a plan that satisfies a safe harbor, it must still satisfy Minimum Coverage, and other applicable General Nondiscrimination requirements. If ordinary after-tax employee contributions are allowed, these contributions are still subject to the ACP Test, but Roth after-tax contributions to a safe harbor plan are not subject to the ACP Test because they are treated like employee elective deferrals.

Section Six: Design-Based Safe Harbors

1. Design-Based Safe Harbors

To qualify for the Design-Based Safe Harbors which were created by the Small Business Job Protection Act of 1996 (SBJPA), plans must satisfy both a Contribution and a Notice Requirement.

a. Contribution Requirement

To satisfy the Contribution Requirement, a plan must provide a “basic matching formula,” an “enhanced matching formula,” or a “nonelective contribution formula” as described below. Employer-matching and nonelective contributions used to satisfy the safe harbors must be nonforfeitable and subject to withdrawal restrictions prior to the occurrence of a triggering event: separation from service, disability, plan termination, attainment of age 59½ or death.

b. Basic Matching Formula

- i. All eligible NHCEs who elect to contribute up to 3% of their compensation⁵ to the plan must receive a 100% employer-matching contribution, and
- ii. All eligible NHCEs who elect to contribute more than 3% of their compensation must receive a 100% match on the first 3% they contribute and a 50% match on additional contributions up to 5% of compensation. Matching contribution rates for HCEs cannot exceed matching rates for NHCEs with the same level of elective contributions.

Example of Basic Matching Formula plan

Institution XYZ’s plan provides a 100% match on employee contributions of up to 3% of compensation and a 50% match on additional employee contributions up to 5% of compensation. No matches are provided for the portion of employee contributions over 5% of compensation.

Employee	EE contribution	ER match
A	2%	2%
B	4%	3.5%
C	5%	4%
D	7%	4%

- Employee A receives a 2% match (100% of 2%)
- Employee B receives a 3.5% match (100% of 3% + 50% of 1%)
- Employee C receives a 4% match (100% of 3% + 50% of 2%)
- Employee D receives a 4% match (100% of 3% + 50% of 2% + 0% of 2%)

Note: The design-based safe harbors require immediate 100% vesting for all employer contributions.

⁵ Generally a plan should use W-2 wages as reported in Box 5, but certain statutory definitions of compensation are also acceptable and any reasonable definition that passes the Compensation Ratio Test (page 7) is also acceptable. (See definition of compensation on page 49.)

1. Design-Based Safe Harbors (continued)

c. Enhanced Matching Formula

- i. Matching contributions for all eligible NHCEs must at least equal contributions they would receive under a Basic Matching Formula,
- ii. Matching rates must not be higher for employees contributing higher percentages of compensation, and
- iii. Matching contributions cannot be provided for employee contributions in excess of 6% of compensation.

Example of Enhanced Matching Formula Plan

Institution ABC’s plan provides a 150% match on employee contributions of up to 2% of compensation and a 100% match on additional employee contributions up to 6% of compensation. No matches are provided for the portion of employee contributions over 6% of compensation.

Employee	EE contribution	ER match
A	2%	3%
B	4%	5%
C	5%	6%
D	7%	7%

- Employee A receives a 3% match (150% of 2%)
- Employee B receives a 5% match (150% of 2% + 100% of 2%)
- Employee C receives a 6% match (150% of 2% + 100% of 3%)
- Employee D receives a 7% match (150% of 2% + 100% of 4% + 0% of 1%)

d. Nonelective Contribution Formula

All eligible NHCEs must receive nonelective employer contributions⁶ of at least 3% of compensation regardless of whether or not they elect to contribute to the plan themselves. Matching contributions for elective contributions of up to 6% of compensation can also be provided, but matching contribution rates can’t be higher for employees contributing higher percentages of compensation. No HCE can receive a higher rate of match than any NHCE with the same or lower rate of elective contributions.

Example of Nonelective Contribution Formula

School ABC’s plan provides all eligible employees a base employer contribution equal to 3% of their compensation. Employees who elect to make contributions receive a 100% match on contributions up to 6%.

Note: Plan sponsors are not allowed to take into account the permitted disparity rules for purposes of satisfying the Nonelective Contribution Formula (see page 9 for an explanation of permitted disparity rules).

⁶ A nonelective employer contribution is one which must be made whether or not the employee elects to make employee contributions.

2. Automatic enrollment safe harbors

For contributory plans that adopt automatic enrollment features for their plans, the Pension Protection Act of 2006 created additional safe harbor alternatives to the ADP and ACP Tests in plan years beginning after December 31, 2007. In an automatic enrollment (also referred to as “negative election”) plan, all employees eligible for the plan are automatically enrolled in the plan at a specified contribution rate and with contributions going into a default investment option selected by the plan sponsor. After the initial automatic enrollment, an employee can make a voluntary election to not participate in the plan, to contribute a different percentage of compensation to the plan, and/or transfer funds or change future contribution allocations out of the default investment option to other investment options offered under the plan.

Unlike the SBJPA safe harbors, the auto enroll safe harbors do not require immediate 100% vesting for all employer contributions. But employer contributions to an auto enroll safe harbor plan must vest within two years of an employee’s automatic enrollment in the plan.

a. Default employee contribution rate. The default employee contribution rate, which will apply to each employee eligible for the plan (unless he or she opts out of participation or signs a salary deferral agreement with another contribution rate) must:

- Be at least 3% through the end of the first full plan year following the year in which automatic enrollment began, 4% in the second full plan year, 5% in the third full plan year, and 6% in the fourth and subsequent full plan years, but
- Never exceed 10%.

Examples

a. Sample qualifying default employee contributions:

- i. ABC School’s plan has a default contribution rate of 3% through the end of the first full plan year of automatic participation, 4% in the second year, 5% in the third year, and 6% in the fourth and subsequent years.
- ii. CDE School’s plan has a 6% default contribution rate in the first and all subsequent years.
- iii. XYZ’s plan has a default contribution rate of 3% in the first year of automatic participation, 6% in the third through tenth years, and 10% in the eleventh and subsequent years.

b. Required employer contribution: In addition to requiring a default employee contribution rate, to satisfy safe harbor requirements, an auto enroll plan must also provide either:

- i. A nonelective employer contribution of at least 3% for all eligible NHCEs regardless of whether they have changed their contribution percentage from the default rate or even if they have elected not to make any employee contributions at all.
- ii. An employer match for all NHCEs equal to at least 100% for contributions of up to 1% of compensation and 50% for contributions between 1% and 6%, with no match for employee contributions in excess of 6% of compensation.

Note: Plan sponsors generally are allowed to make nonelective or matching contributions for HCEs as long as they make them for all eligible NHCEs.

Examples

- i. Example of Nonelective Contribution Formula. School ABC’s plan provides all eligible employees a base employer contribution equal to 3% of their compensation.
- ii. Example of a Matching Plan Formula. XYZ Medical Center’s plan provides an employer match of 150% for employee contributions up 3% of compensation and a 50% match for contributions between 3% and 6% of compensation.

3. Notice requirement

For the ACP/ADP design-based and auto enroll safe harbors, within a reasonable period before the start of the plan year, all employees eligible for the plan must be given a written explanation of their rights and duties under the plan.

The notice must include the contribution formula (including matching, nonelective and discretionary employer contributions) and the conditions under which the contributions are made. The notice must also describe the type and amount of compensation that employees can contribute, and the timing and procedures for signing a salary deferral agreement to begin, alter or terminate elective deferrals. Vesting and withdrawal provisions and contact information for obtaining additional information on the plan must also be described. For auto enroll safe harbors, information about the default investment rate and an employee's rights to opt-out of participation, modify the level of his or her contributions, or change investment allocations must also be provided.

Example

The reasonable period requirement is deemed satisfied if notice is given to each eligible employee at least 30 (and not more than 90) days prior to the beginning of the plan year. Employees who become eligible during the year must receive notice no more than 90 days prior to their date of eligibility.



Did your plan fail to meet the requirements?

If your voluntary contributory plan does not satisfy the requirements of either the design-based or auto enroll safe harbors, it will have to pass the ADP and/or ACP Tests. And if your plan permits after-tax employee contributions, the ACP Test applies to these contributions even if the plan qualifies for one of the safe harbors.

Section Seven: Universal Availability Rule

Applies to:

- All 403(b) plans that provide for employee elective deferrals (both pretax salary reduction and, if permitted by the plan, after-tax Roth 403(b) contribution)

Does not apply to

401(a) plans

Good to know:

Generally, elective deferrals must be available to employees ineligible for your voluntary contributory 403(b) retirement plan only because they have not met the eligibility waiting period—that waiting period can't apply to your supplemental 403(b) plan. Certain classes of employees may be excluded, as detailed on [page 53](#).

Many sponsors of both 403(b) and qualified retirement plans, especially public employers not eligible to set up new 401(k) plans, also have a 403(b) plan to offer employees the opportunity to defer salary. If the 403(b) plan is made available to any employees, it must be made available to all nonexcludable employees. It is not necessary to apply the ADP Test to the employees' deferrals to the 403(b) plan as it is required for 401(k) plans. But if employer contributions to a qualified plan are conditioned on an employee making contributions to a 403(b) plan, then the employer contributions to the qualified plan will be subject to the Matching (ACP) Test. Likewise, if matching contributions are made to the 403(b) plan itself, the 403(b) plan will be required to satisfy the ACP test.

Who?

All 403(b) plans providing for employee elective deferrals (pretax salary deferral and, if permitted by the plan, Roth 403(b) contributions) are subject to the Universal Availability Rule, unless the plan is sponsored by a steeply church. This rule applies to both supplemental 403(b) plans as well as voluntary contributory 403(b) retirement plans. Generally, a nonexcludable employee ineligible for the contributory 403(b) retirement plan or unwilling to make the minimum contribution required for an employer match must be given the opportunity to make elective deferrals under a supplemental 403(b) plan.

When?

Voluntary elective deferrals (salary deferral and, if permitted by the plan, Roth 403(b) contributions) must be available to all nonexcludable employees on a nondiscriminatory basis at all times.

Impact?

If your 403(b) plan fails to satisfy this Universal Availability Test, the tax status of all elective deferrals for that year would be jeopardized.

Section Seven: Universal Availability Rule

How to determine the group to whom 403(b) elective deferrals must be available:

From the group of all employees, you may exclude from participation in your 403(b) plan (but certainly aren't required to exclude) the following groups⁷:

- Students for whom you're not required to withhold FICA and FUTA taxes;
- Participants in a Section 457 governmental plan and employees eligible to participate in a 401(k) or other 403(b) tax-deferred savings plan you sponsor;
- Nonresident aliens who receive no U.S.-source earned income from the employer;
- Employees who cannot or will not contribute at least \$200 a year;
- Employees who are expected to work fewer than 20 hours a week;

The 403(b) regulations provide that an employee can be considered to work fewer than 20 hours a week only if:

- On the date the employee's employment commenced, and during the succeeding 12-month period, the employer reasonably expects the employee to accrue fewer than 1,000 hours of service, and
- For each subsequent 12-month period during which the employee is excluded under this rule, the employee actually accrued fewer than 1,000 hours in the preceding 12-month period.

In addition to the exclusions indicated above, 403(b) regulations provide relief for:

- Individuals who have taken a vow of poverty will still be excludable if their compensation is not treated as wages for purposes of income tax withholding.
- Visiting professors can still be excluded for up to one year if they continue to receive compensation from their home university and be eligible for its 403(b) plan.

⁷ If one employee in an excludable class is eligible, then all employees in the class must be eligible. There is no need to review actual elections or compare HCE deferrals to NHCE deferrals. This test is one of availability, not of actual elections. This test also applies to governmental plans (e.g., plans sponsored by state universities and colleges or public K-12 schools), but not to steeple churches.

Section Eight: Sample Plans

The sample plans show snags you might encounter in the testing process.

We've ordered the tests to parallel the order you might want to follow to make the testing process efficient for that particular plan design.

Each sample covers:

- How to test four types of institutions
- Where the plan(s) might fail
- How to remedy the failure

Institution A

Institution A's retirement plan is somewhat atypical but answers the popular query "What will pass without too much testing?" It may, therefore, become a typical plan.

Plan Type: 403(b) or 401(a) qualified defined contribution retirement plan

Eligible Group: All full-time employees

Waiting Period: 1 year, no exceptions

Minimum Age Requirement: 21, no exceptions

Contributions:

- Employer: 10% below SSWB⁸
15% above SSWB
- Employee: none (noncontributory)

Definition of Compensation for Contributions: Box 1 W-2 Wages plus 403(b) and cafeteria plan deferrals

	Nonexcludable employees	Employees benefiting
HCE	63	63
NHCE	287	287
Total	350	350

- Minimum Coverage Test (Ratio Percentage)
NHCE Ratio: $287/287 = 100\%$
HCE Ratio: $63/63 = 100\%$
 $100\% > 70\% \times 100\%$
- Compensation uses permitted definition
- Integration uses permitted disparity
- General Nondiscrimination:
 - Amounts testing: satisfies design-based safe harbor; no further testing necessary.
 - Other benefits, rights and features: Passes since they are same for all employees.

Summary

The plan passes all the tests, so no modifications are necessary.

⁸ SSWB: Social Security Wage Base.

Section Eight: Sample Plans

Institution B

Institution B's retirement plan includes a couple of potential problems (i.e., the waiting period is waived for employees who participated in a prior employer's plan and contributions aren't based on total compensation). The plan will probably have to rely on the General Test to satisfy General Nondiscrimination requirements, since the plan does not base contributions on total wages.

Plan Type: 403(b) or 401(a) qualified retirement plan

Eligible Group: All full-time employees

Waiting Period: 2 years; waived for employees who participated in a prior employer's retirement plan. (Because of the waiver, employees can't be excluded for not satisfying the plan's minimum service requirements.)

Minimum Age Requirement: 21, no exceptions

Contributions:

- Employer: 7% below 50% of the Social Security Wage Base 12% above 50% of the Wage Base
- Employee: none (noncontributory)

Definition of Compensation for Contributions:

Base Salary

	Nonexcludable employees	Employees benefiting
HCE	95	94
NHCE	405	365
Total	500	459

a. Compensation Definition

Doesn't use permitted definition, so unless it satisfies the Compensation Ratio Test (**page 7**) contribution percentages will have to be recalculated based on an acceptable definition of compensation when testing for General Nondiscrimination (see **page 49**).

b. Social Security Integration

Exceeds permitted disparity limits (see **page 9**), so individual percentages are calculated using permitted disparity when testing for General Nondiscrimination.

c. General Nondiscrimination

Because of (a) and (b) above, rate group testing under the General Test is required (see **page 21**).

d. Minimum Coverage

Try the Ratio Percentage Test (see **page 14**). The HCE benefiting percentage is 98.9% (94/95) and the NHCE benefiting percentage is 90.1% (365/405), so the plan passes [90.1% > 69.2% (70% of 98.9%)].

Summary

Changes may have to be made in order for the plan to meet the statutory nondiscrimination requirements. Possible changes might include using one of the specified definitions of compensation (see **page 49**), and integrating the plan with Social Security at one of the explicitly permitted integration levels (see **page 8**). If these changes are made, the plan will fit within the General Nondiscrimination design-based safe harbor for amounts testing. The other potential problem lies in the exception to the waiting period. Because of the waiver, the plan will have to pass the Minimum Coverage Test without excluding employees who don't meet the plan's minimum service requirement. Giving credit for prior related industry service may be a better alternative (see **page 10**).

Section Eight: Sample Plans

Institution C

Institution C offers an age-graded noncontributory plan with a broad range of contribution rates.

Plan Type: 403(b) or 401(a) qualified defined contribution

Eligible Group: All full-time employees

Waiting Period: 1 year, no exceptions

Minimum Age Requirement: 26, no exceptions

Contributions:

- Employer: 5% for ages 26-34
10% for ages 35-49
15% for ages 50+
- Employee: none (noncontributory)

Definition of Compensation for Contributions: Box 5 W-2 (Medicare) wages

	Nonexcludable employees	Employees benefiting	5% benefiting	10% benefiting	15% benefiting
HCE	20	20	0	3	17
NHCE	115	115	15	35	65
Total	135	135	15	38	82

a. **Compensation Definition** uses definition specified in regulations.

b. **Minimum Coverage**

Since 100% of nonexcludable NHCEs benefit under the plan, it clearly meets minimum coverage requirements without testing.

c. **General Nondiscrimination**

The plan is not designed to qualify for the Uniform Points Safe Harbor (**page 20**), so we'd try the rate group method under the General Test (**page 21**).

Summary

This plan offers a great disparity in its contributions rates and concentrates HCEs in the higher rates. It will not satisfy the General Nondiscrimination Design-Based Safe Harbor, which leaves only the General Test. Under the General Test, the plan will be tested using rate groups. Each rate group will have to satisfy one of the minimum Coverage Tests.

If necessary, the contribution percentages for the rate groups can be adjusted to take into account permitted disparity (**page 23**). Given employee demographics for this plan, it is likely to satisfy General Nondiscrimination requirements.

Section Eight: Sample Plans

Institution D

Institution D offers a noncontributory plan to staff and a contributory plan to others.

Plan A

Plan Type: Noncontributory 401(a) plan

Eligible Group: Full-time staff employees

Waiting Period: 1 year, no exceptions

Minimum Age Requirement: 21, no exceptions

Contributions:

- Employer: 7%
- Employee: none (noncontributory)

Definition of Compensation for Contributions:

W-2 wages, plus 401(k), 403(b) or 401(a) qualified and cafeteria plan salary deferrals

Summary

Plan A automatically satisfies all tests because no HCEs benefit.

	Nonexcludable employees	Employees benefiting
HCE	40	0
NHCE	210	105
Total	250	105

Plan B

Plan Type: Contributory 401(k) plan

Eligible Group: Full-time faculty and administration

Waiting Period: 1 year, no exceptions

Minimum Age Requirement: 21, no exceptions

Contributions:

- Employer: 10% matching
- Employee: 5% voluntary

Definition of Compensation for Contributions:

W-2 wages, plus 401(k), 403(b) or 401(a) qualified and cafeteria plan salary deferrals

	Nonexcludable employees	Employees benefiting
HCE	40	40
NHCE	210	105
Total	250	145

Section Eight: Sample Plans

a. **Compensation** uses permitted definition.

b. **General Nondiscrimination**

If Plan B passes the ADP and ACP Tests, it passes the General Nondiscrimination Test as related to contributions.

c. **Minimum Coverage Test**

Fails Ratio Percentage:

NHCE Ratio = $105/210 = 50\%$

HCE Ratio = $40/40 = 100\%$

$50\%/100\% = 50\% < 70\%$

So try the Average Benefits Test:

Prong 1 – Nondiscriminatory Classification

NHCE Concentration Percentage = $210/250 = 84\%$

Safe Harbor Percentage = 32%

Unsafe Harbor Percentage = 22%

HCEs benefiting = $40/40 = 100\%$

NHCEs benefiting = $105/210 = 50\%$

$50\%/100\% = 50\% > 32\%$

So the plan passes Prong 1 of the test.

Prong 2 – Average Benefits Percentage Test

Calculate the NHCE Average Contribution Percentage (NHCE-ACP) and the HCE-ACP for all nonexcludable employees using employees benefiting in either plan, and apply the Average Benefits Test. If the NHCEs' actual participation in Plan B is good, it should pass this prong of the test.

d. **ADP Test**

Apply this test based on actual participation only in Plan B (the 401(k) plan). If the percentage of eligible NHCEs actually participating in the plan is high, it should pass this test.

e. **ACP Test**

Apply this test based on actual participation only in Plan B. If the percentage of eligible NHCEs actually participating in the plan is high, it should pass this test.

Summary

Plan B may encounter trouble in the Minimum Coverage, ADP and ACP Tests. The only other concern is the amount of testing this program involves; ultimately, the College may want to provide the same benefits to all classes of employees.

Section Nine: Appendix

A. Glossary of Terms	49	B. Plan Outline	61
1 Automatic Enrollment	49	C. Sanctions for Failing	62
2 Benefiting	49	D. Treatment of Collectively Bargained Employees	62
3 Benefits, Rights and Features	49	E. Plan Requirement Summaries	63
4 Compensation	49	1 Governmental Plans	63
5 Contributory Plan/Noncontributory Plan	51	2 Section 401(a), 401(k) and 403(a) Qualified Plans	63
6 Controlled Group	51	3 Section 403(b) Plans	63
7 Cross Testing	51	4 Church Plans	63
8 Elective Deferrals	52	F. Nondiscriminatory Classification: Safe and Unsafe Harbors	64
9 Employer	52	G. Contribution and Compensation Limits	64
10 Excludable Employee/ Nonexcludable Employee	53		
11 Highly Compensated Employee (HCE)	55		
12 Integrated Plan	56		
13 Irrevocable Salary Reduction Agreement/Mandatory Plan	56		
14 Non-Highly Compensated Employee (NHCE)	57		
15 Plan	57		
16 Qualified Matching Contribution (QMAC)—Not Applicable to 403(b) Plans	58		
17 Qualified Nonelective Contribution (QNEC)	58		
18 Rate Group	59		
19 Roth Contributions	59		
20 Safe Harbor	59		
21 Snapshot Testing	60		
22 Three-Year Testing	60		
23 Voluntary/Mandatory Plan	61		

A. Glossary of terms

1. Automatic Enrollment

In 401(k) and 403(b) salary deferral plans with automatic enrollment (also known as negative election), all employees eligible for the elective deferral plan are automatically enrolled in the plan at a specified contribution rate with contributions going into a default investment option selected by the plan sponsor. An employee can subsequently make an election to not participate in the plan, to contribute a different percentage of compensation and/or to transfer funds or change future contribution allocations from the default investment option to other investment options offered under the plan.

Typically, automatic enrollment requires employees to have a predetermined percentage of their pay (usually 3%) deferred to the plan as soon as they become eligible to participate, unless the employee affirmatively elects otherwise. Employers who add an auto enroll feature to a pre-existing elective deferral plan often apply automatic enrollment only to new hires.

Many sponsors of contributory 401(k) or 403(b) plans that add auto enroll to their plans do so because they have been having difficulty passing the ADP Test (see **Section 5**) and/or the ACP (Matching) Test (see **Section 4**). Automatic enrollment will often increase participation by NHCEs, but it does not guarantee passing the tests. Thanks to the Pension Protection Act of 2006, however, auto enroll plans that meet safe harbor requirements (see **Section 6**) automatically satisfy ADP and ACP requirements without having to conduct the Tests as long as the plans do not accept after-tax employee contributions.

2. Benefiting

An employee is considered to benefit under a noncontributory plan (or under a plan using irrevocable salary deferral or mandatory employee contributions) only if an employer contribution is made for him or her under the plan. On the other hand, an employee is considered to benefit under a contributory plan if he or she is eligible to participate in the plan, whether or not actually participating. For purposes of the Average Benefits Percentage, ADP and ACP (Matching) Tests, employees eligible but not participating in contributory plans are considered to be benefiting; therefore, they must be taken into account for calculation purposes. Their contribution percentage is zero.

3. Benefits, Rights and Features

The term “optional forms of benefits” means any type of distribution option that is available under the plan. Early retirement options, lump-sum payout options, as well as standard lifetime annuity payouts are all examples of optional forms of benefits.

The term “right or feature” generally means any right or feature of the plan that is available to participants and is of more than insignificant value. Examples include investment options, transfer options and loan provisions.

Optional forms of benefits and other rights and features must be made available on a nondiscriminatory basis.

For contributory plans, the right to each rate of matching contribution and the right to make each rate of elective contributions or after-tax contributions are rights or features that must be made available on a nondiscriminatory basis. Age or service-graded matching plans must test each grade for nondiscriminatory availability, even if the plan passes the ACP Test.

If a defined contribution and a defined benefit plan are combined to pass the Minimum Coverage Test, the plans must also be combined for purposes of the General Nondiscrimination Test. However, a special rule may be available when testing the availability of certain benefits, rights or features that are not considered “core” benefits and which aren’t uniformly available to all employees eligible under the combined plan.

4. Compensation

For determining who is a highly compensated employee (**page 55**), you should generally use W-2 compensation. For purposes of applying the General Nondiscrimination Test, the Average Benefits Test, the ADP Test, the ACP Test or the Design-Based Safe Harbors, you can use one of the definitions of compensation specified in IRS nondiscrimination regulations or any reasonable definition of compensation that passes the Compensation Ratio Test (**page 7**).

Section Nine: Appendix

Different definitions of compensation may be used for testing different plans or the same plan in different plan years. But when testing any single plan (or multiple plans being tested together) in any given year, the same definition of compensation must be used for all employees.

You can use the Box 5 amount from employees' W-2s (Medicare wages) to determine compensation for nondiscrimination testing purposes. Many employers choose to use this definition of compensation for nondiscrimination testing purposes because it is typically easy to obtain and the amounts listed on Box 5 of the W-2s can be used without any adjustments.

You can use the Box 1 amount from employees' W-2s, but you will need to adjust the reported amounts by adding any salary deferral amounts contributed to benefit plans such as:

- 401(k) or 403(b) retirement plans
- Cafeteria plans (Section 125 plans)
- Simplified Employee Pension (SEP) plans
- 457(b) deferred compensation plans, or
- Section 132(f) transportation fringe benefit plans

Another definition of compensation the regulations permit to be used for nondiscrimination testing purposes is Section 415 compensation as defined in the Internal Revenue Code.

Most employers will use one of the definitions given above for nondiscrimination testing, but you may use any other reasonable definition if it does not, by design, favor HCEs and it passes the Compensation Ratio Test (**page 7**).

The following chart will help you decide which elements of compensation must be included to determine who is highly compensated for nondiscrimination testing and for calculating contribution percentages, if you've selected the definition based on Box 1 W-2 compensation. Other adjustments may be required if you use other definitions and no adjustments need to be made if you use the Box 5 W-2 amount.

Type of Compensation	Include for HCEs	Include for N/D Tests	Comments
Base taxable salary, overtime, summer pay, bonuses	yes	yes	
403(b) employer contributions	no	no	
401(a), 403(a) or 401(k) employer contributions	no	no	
Employer (nonelective) cafeteria plan (125), SEP [402(a)] contributions	no	no	
Employee elective deferrals: 401(k), 403(b), 457(b), 125, 132(f) and 402(h)	yes*	optional**	*except for 457(b) **all or none
Compensation over the current 401(a)(17) limit	yes	no	
Taxable reimbursements, expense allowances, fringe benefits, moving expenses, deferred compensation and welfare benefits	yes	yes*	*may all be excluded
Nontaxable dependent care, educational assistance and 132 (minimal) fringe benefits	no	no	This is dependent care paid for by the employer; salary deferral dependent care is IRC Sec. 125.
Taxable employer-provided housing & related benefits	yes	yes	
Nontaxable employer-provided housing and related benefits	no	no	
Foreign income excluded or not	yes	yes	
Taxable benefits from 457 or other deferred compensation	yes	yes	
Taxable benefits from 401(a), 401(k), 403(a) or other retirement plans	no	no	
Imputed value of employer paid group life above \$50,000	yes	no*	*If a definition specified in the regulations is used.
Taxable sick pay and short-term disability (up to 6 months)	yes	yes	
Employer-provided long-term disability (beyond 6 months)	no	no	
Workers' compensation benefits - no HCEs' taxable benefits from discriminatory self-insured medical plans	yes	yes	
Compensation to minister for church or religious order duties	yes	yes	
Any other W-2 taxable compensation	yes	yes	

Section Nine: Appendix

5. Contributory Plan/Noncontributory Plan

A voluntary contributory or “matching” 401(k) or 403(b) plan is one that requires employee elective deferrals (pretax or Roth) as a condition of receiving employer contributions and is subject to the ADP and/or ACP (Matching) Tests (see **Sections 5** and **4**). The elective deferrals employees must make to get employer contributions under such plans are not required as a condition of employment. In addition, plans that allow ordinary after-tax employee contributions will also be subject to the ACP Test, even if the after-tax contributions are not matched. But Roth 401(k) or Roth 403(b) after-tax contributions are not subject to the ACP Test (see **page 58**).

The only type of qualified plan that can accept elective deferrals is a 401(k) plan. Matching 401(k) plans are subject to both the ACP and the ADP Tests.

Although qualified plans other than 401(k) plans cannot accept elective deferrals from employees, some institutions permit after-tax contributions to their 401(a) or 403(a) plans or set up 401(a) or 403(a) plans to which only employer contributions to match voluntary employee elective deferrals to a 403(b) plan are made.

A noncontributory plan is one funded entirely by employer contributions. In addition, contributory plans which require employee elective deferrals as a condition of employment (“mandatory” contributory plan) or where employee elective deferrals are made pursuant to a one-time irrevocable election (see **page 56**) are treated as noncontributory plans for purposes of applying the Nondiscrimination Tests. Employee elective deferrals under these plans are treated as employer contributions for testing purposes.

6. Controlled Group

The final 403(b) regulation package included regulatory guidance under Section 414(c) that requires tax-exempt employers in the same control group to be treated as a single employer for many purposes, including the nondiscrimination testing applicable to employer-funded 403(b) and 401(a) retirement plans.

Under the control group rules, a group of organizations or subsidiaries must be treated as a single employer for testing purposes, if they are all under common control. These rules are difficult to apply to tax-exempt organizations because they describe controlled groups in terms of stock ownership and profit interests, which are only relevant to for-profit organizations. The rules may be applicable, however, if a tax-exempt employer controls a for-profit subsidiary.

The Section 414(c) guidance provides some clarification by specifying that the “employer” in a controlled group includes not only the organization whose employees participate in the 403(b) or 401(a) plan being tested, but also any other tax-exempt organizations under “common control,” based on 80% of the directors or trustees being either representatives of, or directly or indirectly controlled by, the same exempt organization.

The Universal Availability Rule (**page 41**) that applies to 403(b) salary deferral plans is applied separately to each common law 501(c)(3) organization, even if they are members of a controlled group.

For government plans, the Universal Availability Rule is applied separately to each entity that is not part of a group with a common paymaster. In addition, government employers can elect to apply the Universal Availability Rule separately to each entity that is geographically distinct from related entities and that operates independently on a day-to-day basis.

7. Cross Testing

Under current regulations, it is possible to test a defined contribution plan on the basis of benefits or a defined benefit plan on the basis of contributions. This may be helpful when an institution has both a defined contribution and a defined benefit plan and needs to aggregate them in order to meet nondiscrimination requirements. Cross testing is also helpful for many age- or service-graded defined contribution plans. Typically, a disproportionate share of NHCEs are young and/or short-service, and therefore, get low contributions, but their contributions convert into larger benefit equivalents than similar contributions for employees closer to retirement age. Cross testing is, however, a complex process and generally requires actuarial assistance.

Section Nine: Appendix

Cross testing is not allowed for voluntary contributory plans, which makes passing the ADP and/or ACP Tests difficult for age- and service-graded contributory plans. Furthermore, with the repeal of Notice 89-23, age- or service-graded matching plans must test each grade for nondiscriminatory availability, even if the plan passes the ADP and/or ACP Tests. And many of these plans will have problems passing the nondiscriminatory availability test since HCEs tend to be older, longer-service employees.

8. Elective Deferrals

Some qualified defined contribution and 403(b) retirement plans are funded solely with employer contributions (noncontributory plans), other plans require all eligible employees to contribute to a 401(k) plan, or to a 403(b) plan. Other plans require contributions as a condition of employment and some plans have automatic enrollment features whereby employees are automatically enrolled in a 401(k) or 403(b) plan at a specified contribution rate unless they elect out of participation or elect to change their contribution rate. But many qualified defined contribution plans are voluntary contributory plans in which employees receive employer-matching contributions only if they voluntarily sign a salary deferral agreement with the plan sponsor. Most 403(b) plans are either:

- Voluntary contributory plans in which employees receive employer-matching contributions only if they voluntarily sign a salary reduction agreement with the plan sponsor, or
- Supplemental elective deferral plans funded solely by voluntary employee elective deferrals as elected by the employee under a salary reduction agreement between the employee and the plan sponsor.

An employee elective deferral to a 401(k) or 403(b) plan may take the form of either a pretax contribution or a Roth contribution (see definition of Roth contributions on [page 59](#)). Employee elective deferrals are not permitted to qualified plans other than 401(k) plans, but some plan sponsors solve this problem by setting up two plans:

- A 403(b) plan for voluntary employee elective deferrals, and
- A 401(a) or 403(a) plan to which employer contributions are made only to match employee contributions to the 403(b) plan.

9. Employer

Before you can identify nonexcludable employees, you must identify the employer. The final 403(b) regulation package contained guidance on the control group rules that require tax-exempt employers in the same control group (discussed on [page 51](#)) be treated as a single employer for many purposes, including nondiscrimination testing.

Control group rules: Under the IRC Section 414(b) and 414(c) control group rules, a group of organizations or subsidiaries must be treated as a single employer for testing purposes, if they are all under common control. These rules were difficult to apply to tax-exempt organizations because the rules describe control groups in terms of stock ownership and profit interests, which are only relevant to for-profit organizations. The rules may be applicable, however, if a tax-exempt employer controls a for-profit subsidiary.

The 414(c) guidance provides some clarification for nondiscrimination testing of employer-funded 403(b) and 401(a) retirement plans by specifying that the “employer” in a controlled group includes not only the organization whose employees participate in the plan being tested, but also any other tax-exempt organizations under “common control,” based on 80% of the directors or trustees being either representatives of or directly or indirectly controlled by the same exempt organization.

The Universal Availability Rule, which applies to 403(b) salary deferral plans ([page 41](#)) is applied separately to each common law 501(c)(3) organization, even if they are members of a controlled group. This rule does not apply to 401(a) plans with a 401(k) feature—those plans are instead subject to ADP.

For government plans, the Universal Availability Rule is applied separately to each entity that is not part of a group with a common paymaster. In addition, government employers can elect to apply the Universal Availability Rule separately to each entity that is geographically distinct from related entities and that operates independently on a day-to-day basis.

The Separate Lines of Business (SLOB) rules allow certain distinct parts of an organization to be treated as separate employers for testing purposes at the employer’s discretion. It’s hard to tell when the SLOB rules can be used by nonprofit employers though, since so far, SLOB regulations have only been issued for plans sponsored by for-profit organizations.

Section Nine: Appendix

10. Excludable Employee/Nonexcludable Employee

An excludable employee is one who is not counted for retirement plan testing purposes. The chart below shows which types of employees are excludable by plan type. Please note that to take advantage of one of these exclusions you must actually exclude all employees in the category from eligibility.

Type of Excludable Employee	Excludable in			Requirements*
	403(b) Retirement Plan	403(b) Salary Deferral Plan	Qualified Plans	
Employees with less than plan's minimum service requirement	Yes	No	Yes	Waiting periods for initial eligibility for employer contributions cannot exceed 1 year (or 2 years for educational institutions if contributions are 100% vested immediately). See note 1 below.
Employees younger than the plans minimum age requirement	Yes	No	Yes	Minimum age for initial eligibility for employer contributions cannot exceed age 21 (or age 26 for educational institutions if contributions are 100% vested immediately). See note 2 below.
Part-time employees who normally work fewer than 20 hours per week	Yes	Yes	No	A part-time employee may be excluded from participation in the plan: During the first 12-month period following the date of hire, only if the employer reasonably expects him or her to work fewer than 1,000 hours during that period. During each succeeding 12-month period, the employee may be excluded only if he or she actually worked fewer than 1,000 hours in the previous 12-month period. See note 3 below.
Nonresident aliens with no U.S. earned income	Yes	Yes	Yes	
Employees covered by collective bargaining agreements	Yes	No	Yes	Retirement plan contributions must be the subject of good faith bargaining.
Students not taken into account for employment tax purposes	Yes	Yes	No	If you don't have to withhold FICA and FUTA for a student employee, you don't have to count that student. See note 4 below.
Employees who are covered by another 403(b), 401(k) or 457(b) plan of the employer	No	Yes	No	
Certain visiting faculty members	No	Yes	No	May be excluded for up to one year if they continue to receive compensation from their home university and are eligible for its 403(b) plan.
Members of a religious order	No	No	No	Employees who have taken a vow of poverty may be excluded if their compensation is not treated as wages for purposes of income tax withholding because they are not considered an employee of the entity sponsoring the 403(b) plan.

*see notes on next page

Section Nine: Appendix

*Notes on requirements

1 Employees with less than the plan's minimum service requirements

- a. Generally, the Internal Revenue Code (IRC) permits excluding employees with less than one year of service.
- b. You may use this exclusion only if the plan excludes from participation all employees not meeting the service requirements. But if the plan covers employees the IRC allows to be excluded, the group can still be excluded when testing the rest of the employees if the excluded group can satisfy minimum coverage requirements on its own (see **page 11** for details).
- c. If your plan includes a provision waiving the plan's service requirements (as opposed to giving credit for related industry service, which is discussed in (d) below) for only some new employees (such as those who participated only with a certain vendor such as TIAA in a prior employer's retirement plan), you can't use this exclusion.
- d. You can give credit for related industry service if certain requirements are met (see **page 10** for details).
- e. If you have no service requirement, you can't exclude employees from the testing population under this provision.
- f. This exclusion isn't available with regard to the Universal Availability Rule that applies to supplemental 403(b) elective deferral plans (see **page 41**).

2 Employees younger than the plan's minimum age requirement

- a. Generally, the IRC permits excluding employees who are younger than 21 years of age.
- b. You may use this exclusion only if the plan excludes from participation all employees not meeting the age requirement.
- c. If your plan includes a provision waiving the plan's age requirements for some new employees (such as those who participated in a prior employer's retirement plan), you can't use this exclusion.
- d. If you have no age requirement, you can't exclude employees under this provision. If your plan covers employees who could be excluded under the IRC, the group can still be excluded when testing the rest of the employees if the group can satisfy minimum coverage requirements on its own (see **page 27** for details).
- e. This exclusion is not available when applying the Universal Availability Rule to supplemental 403(b) elective-deferral-only plans (see **page 41**).

3 Employees who are expected to work fewer than 20 hours per week

- a. You may use this exclusion only if the plan excludes from participation all employees expected to work fewer than 20 hours per week.
- b. "Expected to work" fewer than 20 hours per week is not equivalent to averaging fewer than 20 hours per week. Rather, if when an employer would otherwise become eligible to participate, the employee is expected to work fewer than 1,000 hours in the succeeding 12 month period, that employee may be excluded. However, if during any subsequent 12 month period, the excluded employee does complete 1,000 hours, that employee must be allowed to participate prospectively in the plan.
- c. A plan subject to ERISA that elects to take advantage of the 20-hour-a-week exclusion may not satisfy the 410(b) minimum coverage requirements if any employee excluded under this rule actually works 1,000 hours or more in any 12-month period.
- d. Any 403(b) plan that elects to take advantage of the 20 hour/week exclusion might fail the Universal Availability requirement if any participant that was excluded is determined to have worked 1,000 hours, and was not given the opportunity to participate after having worked the 1,000 hours in a 12 month period.

4 Students not taken into account for employment tax purposes

- a. You may use this exclusion only if the plan excludes all students.
- b. This exception generally applies regardless of the number of hours worked, provided you determine they are not subject to the withholding. Keep in mind that full-time employees are not generally considered students because they do not perform services that are incidental to pursuing a course of study. You should consult with your legal counsel regarding this exclusion.

Section Nine: Appendix

11. Highly Compensated Employee (HCE)

For test purposes, you'll need to determine which of your nonexcludable group of employees are highly compensated employees (HCEs). To do this, you will generally need to look at data for the plan year preceding the year being tested. Generally, Box 1 W-2 compensation plus salary deferral contributions to 401(k) or 403(b) plans, cafeteria plans and SEPs (or Box 5 W-2 compensation without adjustments) is used in determining whether an employee is HCE. See definition of "Compensation" on **page 49** for details. (Note: It's possible to have no HCEs for testing purposes, in which case your plan automatically meets the nondiscrimination testing requirements.) Generally, any of your employees who are not HCEs are treated as non-highly compensated employees (NHCEs).

Standard Definition

Did the employee earn more than the applicable limit in the prior plan year?

If yes, the employee is an HCE. For fiscal year plans, a calendar year election is available (see definition on this page).

Note: While most institutions will use this definition of HCE, employers with large numbers of highly paid employees may have fewer HCEs if they elect to use the Top-Paid Group election described below.

Top-Paid Group Election

- 1 Did the employee earn over the applicable limit from this employer in the prior plan year?
- 2 If the answer to (1) is yes, was the employee within the top 20% of employees ranked by compensation ("top-paid group") in the prior year?

If the answer to both questions is yes, the employee is an HCE.

For fiscal year plans, a calendar year election is available (see definition on this page).

Please note the following rules that apply whether you use the standard or alternative definition of HCE:

- In determining the top-paid group, exclude any employee who:
 - i. Hasn't completed six months of service,
 - ii. Works fewer than 17½ hours per week,
 - iii. Normally works fewer than 6 months a year,
 - iv. Hasn't attained age 21,
 - v. Is a nonresident alien receiving no U.S. earned income, or
 - vi. Is in a collective bargaining unit, providing that at least 90% of all employees are covered by a collectively bargained agreement and the plan being tested covers only non-union employees.
- It's important to keep records since the determination of whether or not an employee is an HCE is based on compensation earned during the preceding year, even if the employee's compensation moves above or below the applicable limit in the current year.
- The compensation level used to determine who is an HCE is indexed.

Calendar Year Election

If the plan year is not the calendar year, a calendar year election for determining HCE status is available. If this election is made, an employee is an HCE if he or she earns the applicable limit or more during the calendar year that begins in the preceding plan year. But even if the calendar year election is made for determining who is an HCE, plan year compensation, instead of calendar year compensation, must be used when calculating contribution percentages for nondiscrimination testing. Few contributory plans with non-calendar plan years make the calendar year election since that would require compiling data for both the calendar and plan years.

- If no employee qualifies as an HCE for testing purposes, your plan automatically meets all nondiscrimination requirements without further testing.
- When conducting ADP and/or ACP testing on a contributory plan using the Prior Year Testing Method, contribution percentages for NHCEs are determined based on compensation and eligibility in the prior year. Note that the determination of who is treated as an NHCE in the prior year is based on compensation earned in the year before that one (which is two years prior to the year being tested).

Section Nine: Appendix

12. Integrated Plan

An integrated plan is one that provides a base contribution on compensation up to a specified level, and a higher, or “excess,” contribution on compensation above that level. Internal Revenue Code Section 401(l) and associated regulations specify the “permitted disparity” between contribution rates above and below the integration level that is deemed nondiscriminatory without further testing. This permitted disparity allows an employer to take into account the fact that employer contributions to Social Security (and the benefits derived from them) are proportionately higher for lower paid employees than for highly paid employees. (See **page 8** for a discussion of Social Security Integration.)

A noncontributory plan can have any degree of disparity between contribution rates above and below the integration level as long as the plan meets General Nondiscrimination requirements. Alternatively, it is not necessary for an integrated noncontributory plan to demonstrate that its contribution schedule is nondiscriminatory if it qualifies for the 401(l) safe harbor.

To qualify for the 401(l) safe harbor, a plan must base contributions on a nondiscriminatory definition of compensation, such as W-2 wages. Also, the integration level cannot be higher than the Wage Base for OASDI portion of Social Security. An integration level below the Wage Base is permitted, as long as the disparity in contribution rates above and below the integration level doesn't exceed specified limits. The maximum disparity in rates above and below the integration level permitted without having to prove that the contribution schedule is nondiscriminatory is the lesser of:

- 1 The employer contribution rate on salary below the integration level, or
- 2 One of the following percentages, whichever is appropriate:
 - 5.7%, if the integration level is 20% of the Social Security Wage Base or less, or is equal to precisely the current Wage Base,
 - 4.3%, if the integration level is more than 20% of the Wage Base, but not more than 80% of the Wage Base, or
 - 5.4%, if the integration level is more than 80% of the Wage Base but less than the Wage Base.

It will generally not be possible to have a contributory plan that is integrated with Social Security. Because you can't count Social Security contributions when conducting the ACP and/or ADP Tests, many employees will have different rates of deferrals and matching contributions under an integrated plan. Regulations require that the right to each rate of matching contributions be tested for nondiscriminatory availability, and HCEs will always have a higher rate of match when this test is applied. These plans should not be designed with an integration formula.

13. Irrevocable Salary Reduction Agreement/Mandatory Plan

A mandatory plan requires all eligible employees to make contributions to the plan as a condition of employment. A 401(a) or 403(b) plan using an irrevocable salary deferral agreement requires the employee to make a one-time decision about whether or not to participate in the plan at the time he or she first becomes eligible to participate in *any* of the employer's plans (so if employees become eligible for a supplemental elective-deferral-only 403(b) plan on date of hire, they will need to make the irrevocable election on their date of hire too). Mandatory plans, and plans using irrevocable salary deferral agreements, are treated as noncontributory plans for nondiscrimination testing purposes (with employee contributions treated as employer contributions, which is advantageous because the ADP and/or ACP Tests will not apply). In addition, the employee contributions are treated as employer contributions for purposes of calculating the limits on contributions (and thus the 402(g) limit on elective deferrals won't apply to these contributions).

If an irrevocable election is used, thus allowing an employee to decline participation, an employee who declines to participate in the plan may never join the plan in the future; nor may an employee who elects to participate discontinue participation while continuing to work for the plan sponsor. A plan using an irrevocable election may still face future problems with the Minimum Coverage nondiscrimination requirements since it will typically be NHCEs who decline to participate and who will be treated as nonexcludable but not benefiting under the plan.

Section Nine: Appendix

14. Non-Highly Compensated Employee (NHCE)

Non-highly compensated employees (NHCEs) are employees who do not qualify as highly compensated employees (HCEs). If you have a contributory retirement plan and elect to apply the ADP and/or ACP Tests (see **Sections 5 and 4**), based on prior year data, a different rule applies, as described below.

When conducting nondiscrimination testing on either contributory or noncontributory retirement plans, all employees with compensation greater than the applicable limit in the prior year. If, however, more than 20% of employees received compensation over the applicable compensation limit in the prior year, the employer can elect to treat only employees within the top 20% of employees ranked by compensation (“top-paid group”) in the prior plan year as HCEs (see **page 55**). Employees must generally be treated as non-highly compensated employees (NHCEs) if they don’t qualify as HCEs.

When testing contributory retirement plans for compliance with ADP and/or ACP requirements (see **Sections 5 and 4**), however, the data used to determine whether or not an employee is an NHCE depends on whether you decide to calculate actual contribution and deferral ratios for your NHCEs on the basis of current or prior year data.

- If you elect to use current year data, then you treat as NHCEs all employees who did not receive compensation during the prior year in excess of applicable limit for that year.
- If you elect to use prior year data, you treat as NHCEs all employees who were NHCEs in the prior year without regard to changes in the group of NHCEs in the testing year. Thus, for testing, the prior year NHCE ADP and/or ACP are used, even if some of the prior year NHCEs are no longer employees or have become HCEs during the current year.

15. Plan

A “plan” is broadly defined for testing purposes by the Internal Revenue Code as a single plan if all plan assets are available to pay benefits. This definition appears to apply more to defined benefit plans than to defined contribution plans. All of an employer’s noncontributory qualified plans are generally treated as a single plan for nondiscrimination purposes, even if they have separate plan documents and file separate 5500 forms. Likewise, all of an employer’s contributory qualified plans are generally treated as a single plan.

If a plan segregates some assets for the exclusive benefit of certain employees, those assets constitute a separate plan. But separate trusts or separate individual accounts or individual annuity contracts or certificates don’t constitute segregated assets.

As explained in **Section 2**, certain plans that are otherwise tested as separate plans may be aggregated for purposes of Minimum Coverage. But any plans that are aggregated for Minimum Coverage must also be aggregated for purposes of General Nondiscrimination. In addition, a single plan may be restructured into component plans for all testing purposes. A component plan consists of all contributions and all benefits, rights and features provided to employees in a component group. The employer can select any number of component groups of employees, but each employee must be in one (and only one) of the component groups. The employer is free to reconfigure the component groups each year.

In addition to all the above, certain single plans as already defined may (or sometimes must) be treated as separate plans in certain situations for certain nondiscrimination tests, according to the chart below.

Also see the definition of “rate group” on **page 58**.

Section Nine: Appendix

Nondiscrimination Test

Part of Plan	Minimum Coverage and General Nondiscrimination Tests	ADP and ACP Tests
1. Union employees*	Each union generally must be tested as a separate plan (even for the Average Benefits Percentage Test). They are deemed to automatically pass tests	Each union is tested as a separate plan. They are deemed to automatically pass
2. Plan with contributory and noncontributory provisions	Must be tested as separate plans	Generally tested as separate plans QNECs may be counted for the ADP and ACP Tests (see Sections 5 & 4)
3. Employees covered by a plan but not meeting the statutory minimum age and service requirements	May be tested as a separate plan at the employer's option if these employees can pass on their own	Tested as a separate plan at employer's option if these employees pass the tests on their own
4. Each separate line of business	May be tested as a separate plan if nondiscriminatory classification requirements are met on an employer-wide basis (see page 52)	May be tested as a separate plan

*Unless 2% or more of the union employees are HCE professional employees (see Appendix D).

16. Qualified Matching Contribution (QMAC)—Not Applicable to 403(b) Plans

“QMACs,” or “qualified matching contributions,” are employer-matching contributions that are always fully vested and are subject to certain distribution restrictions. They are counted along with other matching contributions in the ACP Test for 401(k) plans unless the employer elects to treat them as employee elective deferrals, in which case they are counted in the ADP Test. A QMAC counted in performing the ADP Test may be made up to 12 months after the end of the plan year.

To qualify as a QMAC, matching contributions must meet several criteria:

- Be fully and immediately vested;
- Not be available to the employee as a cash payment as an alternative to a contribution to the plan; and
- Not be available for withdrawal before earliest of age 59½, separation from service, death, qualified reservist distribution or disability.

17. Qualified Nonelective Contribution (QNEC)

QNECs are contributions normally added by the employer to enable a contributory QNEC plan to pass the ADP and/or ACP (Matching) Tests. A QNEC can be counted in performing the ADP and ACP Tests and may be made up to 12 months after the end of the plan year. QNECs included in the calculation for one test cannot also be included when performing the other test; so if QNECs are to be used for both tests, the total amount of QNECs must be large enough to cover the amounts included in each calculation. To qualify as a QNEC, the contributions must meet several criteria:

- Be fully and immediately vested;
- Not be conditioned on employee contributions;
- Not be available to the employee as a cash payment as an alternative to a contribution to the plan; and
- Not be available for withdrawal before earliest of age 59½, separation from service, death, qualified reservist distribution or disability.

QNECs may be voluntarily included in the ADP or ACP Test calculations only if all QNECs pass General Nondiscrimination testing. Also, if only a portion of the QNECs are included in the Test, the portion not included must also satisfy General Nondiscrimination. If only NHCEs receive QNECs, the QNECs satisfy General Nondiscrimination requirements without further testing.

The plan must be amended to grant QNECs to NHCEs who were not eligible for the plan in an amount equal to the matching rate for eligible NHCEs. The amendment must be made by the 15th day of the 10th month following the end of the plan year being corrected.

Section Nine: Appendix

18. Rate Group

Rate groups are part of a single noncontributory plan where the amount of contributions or benefits is being tested for compliance with General Nondiscrimination requirements using the General Test. There is a rate group for each HCE. Each rate group consists of an HCE and all other employees (both HCEs and NHCEs) receiving a contribution rate at least as high as that HCE's contribution rate. (A nondiscriminatory definition of compensation must be used in calculating contribution rates.) Each rate group must satisfy minimum coverage as if it were a separate plan, except as described in **Section 2**, Minimum Coverage.

19. Roth Contributions

Sponsors of 401(k) or 403(b) retirement plans can offer participants the option of making some or all of their contributions in the form of after-tax Roth contributions instead of, or in addition to, pretax salary deferrals to the 401(k) or 403(b) plan. Employees can't take deductions for their Roth contributions to a 401(k) or 403(b) plan, and any Roth contributions they make reduces the amount of pretax contributions they can make to the plan. Nevertheless, Roth contributions are likely to be quite attractive to some employees since qualified distributions are tax free.

Contribution limits

401(k) and 403(b) Roth contributions are considered to be a form of elective deferral and are subject to the same 402(g) limit as pretax elective deferrals. Roth 401(k) and 403(b) contributions are also subject to the overall 415 limit that applies to all employee and employer contributions to defined contribution plans. So, if an employee is already taking full advantage of the contribution limits, any Roth contributions will generally reduce the amount of other type contributions that he or she can make. However, an employee gets separate 415 limits for contributions to qualified and 403(b) plans.

Taxation

Participants will not get an income tax deduction for any Roth 401(k) or 403(b) contributions they make to their retirement plan. But qualified distributions of Roth accumulations will be income tax free—including all of the earnings that have accrued since the contributions were made. Distribution of the actual Roth contributions is always tax free since there was no deduction when the contributions were made. No taxes are paid on earnings on Roth contributions while they remain in the 401(k) or 403(b) plan, and distributions of these earnings will also qualify for tax-free treatment if the date of the distribution is at least five years after January 1 of the year in which the first Roth contribution was made to the plan (or its predecessor in the case of a rollover) and the participant is:

- Age 59½
- Disabled, or
- Deceased

20. Safe Harbor

As the name implies, a safe harbor is a haven from a sea of calculations. The term appears several times in the guide, identifying many different areas where the IRS offers a simplified testing process. Usually, incorporating certain design features or meeting certain basic requirements allows a plan to take advantage of the simplification.

Satisfying a safe harbor doesn't mean that you won't have to keep records or that you'll always be exempt from other testing. For example, the design-based safe harbors for testing amounts of contributions under General Nondiscrimination (**Section 3**) only offers relief from that one test. The design-based safe harbors created by the Small Business Job Protection Act of 1996 for matching plans, and the Pension Protection Act of 2006 for auto enroll plans (**Section 6**), offer 401(k) and 403(b) plans relief only from the ADP and/or ACP Tests.

Section Nine: Appendix

21. Snapshot Testing

Generally, employers must collect and use precise employment, eligibility, participation, compensation and contribution data for the plan year as a whole for nondiscrimination testing. IRS regulations allow employers to use estimates instead of precise data for testing defined benefit plans, but unfortunately this option isn't available to defined contribution plans. But employers can base most nondiscrimination testing of defined contribution plans on the employee workforce on a single day during the plan year (the "snapshot" day) instead of having to collect and use data for the plan year as a whole. That means, for example, that employees hired after (or terminated before) the snapshot day can be excluded from the employee population when testing. Any day during the plan year can be used as the snapshot day, as long as it is reasonably representative in terms of workforce composition and retirement plan coverage, and the same snapshot day is generally used each year.

Unfortunately, snapshot testing isn't available for the ADP and ACP Tests. So an institution with a 401(k) or other voluntary contributory plan (employees and employers share the cost) will generally still have to conduct these tests on the basis of a full year's data. But, of course, a contributory plan can use snapshot testing if it is exempt from the ADP and/or ACP Tests because:

- Participation in the plan is required as a condition of employment (a mandatory plan), or
- All employee contributions to the plan are made under one-time irrevocable salary deferral agreements and the plan doesn't permit after-tax employee contributions.

Even a voluntary contributory plan that is subject to the ADP and/or ACP Tests can substantiate compliance with (1) the Minimum Coverage Test and (2) the current availability of other benefits, rights and features portion of the General Nondiscrimination Test. General safe harbors offer enough simplification and relief that, if you need to redesign your plan anyway, you may want to make design choices that satisfy the safe harbors to reduce the efforts and costs involved in complying with the nondiscrimination testing requirements.

Nondiscrimination Test using snapshot data. This may help some institutions because they can test early in the year and correct any failure by expanding eligibility prior to the end of the plan year.

22. Three-Year Testing

Regardless of whether nondiscrimination testing is done on the basis of annual or snapshot data, employers can conduct testing on a noncontributory plan as seldom as once every three years, as long as there have not been any significant changes since the last test date.

Determining what constitutes a "significant change" is generally a facts-and-circumstances test based on the margin by which the plan passed the nondiscrimination tests the last time they were performed and the likelihood that any changes that have taken place since then would affect test results.

Examples of changes that are likely to be significant are ones involving new legal requirements, or changes in plan provisions, employee population or plan participation.

Unfortunately, three-year testing isn't available for the ADP or ACP Tests. So an institution with a 401(k) or other voluntary contributory plan (employees and employers share the cost) will generally still have to conduct these tests every year on the basis of a full year's data. But, of course, a contributory plan can use three-year testing (and snapshot testing) if it is exempt from the ADP and/or ACP Tests because:

- Participation in the plan is required as a condition of employment (a mandatory plan), or
- All employee contributions to the plan are made under one-time irrevocable salary deferral agreements and the plan doesn't permit after-tax employee contributions.

Even a 401(k) plan that is subject to the ADP and ACP Tests is eligible for three-year testing using snapshot data with regard to the Minimum Coverage Test and the current availability of other benefits, rights and features portion of the General Nondiscrimination Test, which may help some institutions because they can test early in the year and correct any failure by expanding eligibility prior to the end of the plan year.

Section Nine: Appendix

23. Voluntary/Mandatory Plan

Participation in most contributory plans is voluntary. That is to say, that while employees are required to make elective deferrals in order to get employer-matching contributions, making the deferrals is voluntary.

But participation in some plans is mandatory. A mandatory plan requires all employees eligible to participate in a plan to actually make plan contributions as a condition of employment. Eligible employees who refuse to make plan contributions must be fired. Mandatory plans are treated as noncontributory plans for nondiscrimination testing purposes. The required employee contributions to mandatory plans are treated as employer contributions for nondiscrimination testing purposes and, therefore, the plan is not subject to the ADP or ACP Tests. Since the required employee contributions are treated as employer contributions, not elective deferrals, they are not subject to the 402(g) limit on elective deferrals although they, along with all other employee and employer contributions, are subject to the overall Section 415 limit on contributions to defined contribution plans.

B. Plan Outline

We've found it easier to perform the tests if some fundamental plan information is outlined for easy reference. Outline the provisions of each plan at your institution. Make a separate outline for each union plan, different contribution schedules, and so on. You may later combine some of these plans for some or all testing purposes.

Plan# _____

Eligible group _____

Waiting period _____ Any exceptions? _____

Minimum age requirement _____ Any exceptions? _____

Contributions:

Employer _____%

Employee _____%

Pretax? _____%

Roth contribution? _____%

After-tax contribution? _____%

By irrevocable salary deferral agreement? _____

Mandatory plan? _____

Definition of compensation for contributions _____

Benefits, rights and features _____

C. Sanctions for Failing

Internal Revenue Code regulations make it clear that failing to meet nondiscrimination requirements is a plan defect that could result in current taxation of all contributions made to the account of any participant (including both HCEs and NHCEs) in the year the plan first fails. If you discover nondiscrimination compliance problems with your plan, you should consult legal counsel. Your legal counsel should consider the options available for correcting the defects before your plan is audited by the IRS. There are IRS correction programs under the Employee Plans Correction Resolution System (EPCRS) available to you that may allow you to correct the errors.

If you had procedures in effect to prevent violation of nondiscrimination rules but inadvertently committed a violation, you may be able to self-correct using the Self-Correction Program (SCP) without contacting the IRS or paying any penalties. SCP is available to correct failure of the ADP and/or ACP Tests or to make voluntary elective deferral plans universally available. Other 401(a)(4) and coverage failures cannot be corrected under SCP.

If no procedures were in place to prevent violations or you have a failure that is not eligible for correction under SCP, you may want to contact the IRS to discuss the possibility of correcting the defects under the Voluntary Correction Program (VCP). Under this program, certain plan defects can be corrected without fear that the IRS will revoke the plan's tax-exempt status because of the identified defect. But using VCP will require you to contact the IRS and possibly pay fees and penalties. You should contact your own legal advisor to determine your best course of action.

D. Treatment of Collectively Bargained Employees

An employee who is included in a unit of employees covered by a collectively bargained agreement between employee representatives and an employer is a collectively bargained (i.e., "union") employee, for purposes of nondiscrimination testing, provided that there is evidence retirement benefits were the subject of good-faith bargaining.

Union employees must generally be tested separately from non-collectively bargained (i.e., "non-union") employees. If an employer has multiple unions, each union would be tested separately, as would union and non-union employees in the same plan.

Nondiscrimination regulations provide that union plans automatically meet testing requirements unless more than 2% of employees are both HCEs and professionals. In this case, the union employees are treated as non-union employees. Regulations define professional as any employee who performs services as a public accountant, actuary, architect, attorney, chiropractor, chiropractor, executive, investment banker, medical doctor, dentist, optometrist, osteopath, podiatrist, engineer, veterinarian, psychologist, stockbroker or in any other capacity specified by the IRS; it appears that faculty members are not included unless they perform any of these services. Therefore, you probably won't have to perform these tests for your union plans.

E. Plan Requirement Summaries

- 1 Governmental Plans:** Retirement plans at state institutions and other government entities including public schools and state colleges are generally exempt from all nondiscrimination requirements. Exception: Voluntary elective deferral 403(b) plans are subject to the Universal Availability Rule.

Note that the IRS has issued a notice of proposed rulemaking in 2011 that includes a fairly narrow definition of what constitutes a governmental plan. This is the result of a project between the IRS, DOL and PBGC to standardize the definition of governmental plans between the agencies. It is anticipated that the new definition could impact healthcare systems, medical schools, utilities, charter schools and credit unions. No immediate action is required as this definition will not be effective until final guidance is issued which is not expected anytime soon.

- 2 Section 401(a), 401(k) and 403(a) Qualified Plans:** In general, the nondiscrimination requirements that apply to plans qualified under 401(a) or 403(a) of the IRC are:

- General Nondiscrimination [§401(a)(4)],
- Minimum Coverage [§410(b)], and
- ACP Test [§401(m)].

However, elective deferrals to 401(k) plans are also subject to the Actual Deferral Percentage (ADP) Test, which compares deferrals made by HCEs to deferrals made by NHCEs.

- 3 Section 403(b) Plans:** In general, the same nondiscrimination requirements apply to 403(b) plans as those listed above for plans qualified under 401(a) or 403(a) of the IRC, Minimum Coverage [§410(b)], and the ACP Test [§401(m)]. However, elective deferrals to 403(b) plans are not subject to the Actual Deferral Percentage (ADP) Test, which applies to 401(k) plans and requires you to compare deferrals made by HCEs to deferrals made by NHCEs.
- 4 Church Plans:** If a “church” is the employer sponsoring a retirement plan, the plan doesn’t have to meet any nondiscrimination requirements. If an educational institution is not separately incorporated from its controlling church, it qualifies as a church and its plan(s) are church plan(s) provided the school is not subject to FICA tax withholding under IRC Section 3121. In addition, a primary or secondary school, even if separately incorporated, generally qualifies as a church as long as it is “controlled,” operated or principally supported by a church. The church may be local, regional or national.

For a separately incorporated school, which is not a primary or secondary school, such as a college or university, it is very difficult to qualify as a church or “qualified church-controlled organization,” as the law defines it. To do so, two criteria must be met. First, its services (generally education) must be offered at a “nominal charge” which is “substantially less” than the cost of providing such services. Second, less than 25% of its budget may come from either governmental sources or the performance of services, sale of merchandise, or receipts from admissions. So, for example, tuition, government grants and aid, and bookstore profits may not equal as much as 25% of a college’s budget if its retirement plan is to be exempted from nondiscrimination testing as a church plan.

If, however, a plan is sponsored not by the college or university, but by the church it is affiliated with, that plan is exempt from the nondiscrimination rules. It is advisable to have a discussion with your own legal counsel before making a determination that your plan qualifies as a church plan.

Section Nine: Appendix

F. Nondiscriminatory Classification: Safe and Unsafe Harbors

Apply these Safe and Unsafe Harbors when determining nondiscriminatory classifications under the first prong of the Average Benefits Test.

Non-Highly Compensated Employee Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage	Non-Highly Compensated Employee Concentration Percentage	Safe Harbor Percentage	Unsafe Harbor Percentage
60% or less	50.00%	40.00%	80%	35.00%	25.00%
61%	49.25%	39.25%	81%	34.25%	24.25%
62%	48.50%	38.50%	82%	33.50%	23.50%
63%	47.75%	37.75%	83%	32.75%	22.75%
64%	47.00%	37.00%	84%	32.00%	22.00%
65%	46.25%	36.25%	85%	31.25%	21.25%
66%	45.50%	35.50%	86%	30.50%	20.50%
67%	44.75%	34.75%	87%	29.75%	20.00%
68%	44.00%	34.00%	88%	29.00%	20.00%
69%	43.25%	33.25%	89%	28.25%	20.00%
70%	42.50%	32.50%	90%	27.50%	20.00%
71%	41.75%	31.75%	91%	26.75%	20.00%
72%	41.00%	31.00%	92%	26.00%	20.00%
73%	40.25%	30.25%	93%	25.25%	20.00%
74%	39.50%	29.50%	94%	24.50%	20.00%
75%	38.75%	28.75%	95%	23.75%	20.00%
76%	38.00%	28.00%	96%	23.00%	20.00%
77%	37.25%	27.25%	97%	22.25%	20.00%
78%	36.50%	26.50%	98%	21.50%	20.00%
79%	35.75%	25.75%	99% or more	20.75%	20.00%

G. Contribution and Compensation Limits

Contribution limit	2022	2021	2020	2019	2018
HCE limit*	\$135,000	\$130,000	\$130,000	\$125,000	\$120,000
401(a)(17) includable compensation limit**	\$305,000	\$290,000	\$285,000	\$280,000	\$275,000
402(g) limit on elective deferrals	\$20,500	\$19,500	\$19,500	\$19,000	\$18,500
Catch-up limit age 50+	\$6,500	\$6,500	\$6,500	\$6,000	\$6,000
415 limit on employee and employer contributions	\$61,000	\$58,000	\$57,000	\$56,000	\$55,000

*Employees with compensation over the limit in a given plan year are treated as HCEs in the next plan year. (Example: An employee with compensation over **\$130,000** in a plan year beginning in 2021 is treated as an HCE in plan years beginning in **2022**.)

**All retirement plans (except for certain church plans) are subject to the 401(a)(17) limit on the maximum amount of compensation that can be taken into account when calculating retirement plan contributions

