



Professional Benefit Services, Inc.

Additional Information About Plan Testing

Definition of Highly Compensated Employees (HCE)

The HCE group is defined by the IRS as 5% or more owners, spouses of owners, lineal relatives of owners and any employee making greater than \$110,000 in the immediately prior plan year.

Definition of Non-highly Compensated Employees (NHCE)

The NHCE group is defined as all other eligible employees (not HCE). All employees who meet the plan's eligibility requirements are included in the test **whether or not** they actually defer.

IRS Compensation and Deferral Limits for 2011 Testing

The maximum compensation amount that can be considered for testing purposes is limited to **\$245,000**. The maximum deferral limit a 401(k) plan participant may elect for **2011** is **\$16,500 for participants under age 50 and \$22,000 for participants age 50 and older**.

Actual Deferral Percentage Test (ADP)

This IRS-required test is applied to your 401(k) plan to make sure the **Highly Compensated Employees (HCE)** never get a benefit of a certain percentage greater than the average percentage of the **Non-highly Compensated Employees (NHCE)**. All employees who meet the eligibility requirements of the plan are included in the test **whether or not** they are actually deferring. Test failures may result in corporate penalties if the adjustments are not made prior to 2½ months following the plan year end.

Safe Harbor

The IRS allows plans to make a 100% vested contribution which will enable the plan to pass the Actual Deferral Contribution, Actual Compensation Contribution and the Top Heavy tests. Implementation of this provision for the 2012 plan year requires advance notice to employees by December 1, 2011 (for calendar year plans) at the latest. It also requires an employer commitment for 12 months. If you are interested in this provision, please call our office and we'll mail information to you. (New 401(k) plans must have at least a three month short plan year as their first plan year to include the safe harbor contribution.)

Actual Compensation Percentage Test (ACP)

Similar to the ADP test described above, this test makes sure the "Highly Compensated" aren't receiving a greater match by percentage than the Non-highly Compensated. All employees who meet the eligibility requirements of the plan are included in the test **whether or not** they actually defer and receive a match. Again, test failures may result in corporate penalties if the adjustments are not made prior to 2½ months following the plan year end.

Additional Information About How The ADP Test is Performed

The census information provided is first sorted to determine which employees satisfied the eligibility requirements to participate in the plan during the plan year being tested. The eligible employees are then sorted into two groups: the HCE group and the NHCE group. Each eligible employee's compensation for the plan year is then divided by the deferral amount to determine the employee's deferral "rate". Additional calculations may be necessary for employees who were only eligible a portion of the plan year.

Next, the deferral percentage rates of the HCE group and NHCE group are calculated to determine the "average" rate of deferral for each group. If the NHCE's "average" deferral rate is less than 2%, the HCE's can have an "average" deferral rate of 2 times that rate (ex: NHCE average rate is 1.54%, HCE's can defer an average of 3.08%). If the NHCE's average deferral rate is greater than 2%, but less than 8%, the HCE's can add 2% points (ex: NHCE average rate is 3%, HCE's can defer an average of 5%). If the NHCE's average deferral rate is greater than 8%, the HCE's can defer an average of 1.25 times that amount (ex: NHCE average rate is 8%, HCE's can defer an average of 10%).

The IRS requires that the plan document specify whether the NHCE rate for the current or prior year will be used. Your PBS restated plan document will specify your choice. Using the prior year is the most common method. If this is the first year for your plan, the IRS will allow you to use a "prior year" default average NHCE rate of 3% (a NHCE ratio of 3% would allow the HCE group to defer an average of 5%).

If your ADP test fails, additional instructions will be given. There are basically two avenues available to correct the failure. The first is to adjust the HCE's deferrals down until the average percentage passes the test. The second solution would involve the employer making additional employer contributions into the plan for participants. At the time of testing, PBS will automatically adjust the HCE's contributions down rather than recommend additional employer contributions.

Top Heavy Testing

Each plan year, it must be determined whether your plan is "top-heavy." A plan is top-heavy if, as of the determination date, the total account value of Key Employees exceeds 60% of the total account value of all employees in the plan. Total account values are determined using end of year investment statement values plus any employee and employer match contributions still due for that year. Catch contributions for those age 50 and over are also not counted.

The definition of a Key Employee is: 5% owners, 1% owners with over \$150,000 in compensation, and officers with over \$160,000 in compensation. Family members (parents, children, spouses) owners are also Key Employees.

If any Key Employee makes or receives a contribution in the year that a top heavy contribution is due, the employer must make the same percentage non-elective contribution for all Non-Key Employees, up to but not in excess of 3%. For example, if the Key Employee makes a 10% contribution for himself, the employer must make a 3% minimum contribution for all of the eligible Non-Key Employees. However, if the Key Employee only makes or receives 1%, only a 1% contribution will be due. Eligible Non-Key Employees include all employees eligible to participate in the plan, whether or not they are participating.

There are avenues open to the plan to avoid paying the 3% in future years:

- Key Employees and any family members would not participate (defer from pay or receive an employer contribution) in a plan year. If contributions to those identified as “Key” are zero for a plan year, no Top Heavy contributions are due.
- Become a “Safe Harbor” plan and contribute a 4% match to those employees who participate in the plan. This normally requires a plan amendment and a notice to participants distributed between September 1 and November 30, prior to the beginning of the plan year the Safe Harbor contribution is to be made. Ask us for additional information regarding the Safe Harbor provision.
- If all Key Employees are age 50 or over, the plan can be amended to limit Key Employees to the IRS \$5,000 catch up contributions. This would allow Key Employees to put up to \$5,000 in the plan without having to make the top heavy contribution.

New Comparability Testing

The new comparability plan separates eligible employees into different allocation groups as defined in a New Comparability plan document. To use the New Comparability allocations, you must have a Volume Submitter document that allows for New Comparability contributions. If you don't currently have a New Comparability document and would like to install this type of plan, please give our office a call. We can provide an allocation sample that can help you decide whether this is the right type of plan for you and your employees.

Once allocation groups are determined by the document, the census you provided is sorted into these groups. These allocation groups are then assigned a contribution percentage rate. The rates can be different as long as certain minimum contribution requirements are met and as long as the plan can satisfy nondiscrimination testing applicable to the New Comparability allocations.

Minimum contribution requirements: All participants must receive a contribution percentage of at least one third of the contribution percentage given to the highest allocation group or a minimum gateway contribution of at least 5%.

Nondiscrimination testing requirements: Any allocation (including the minimum allocations listed above) must satisfy rate group testing for the allocation to be permissible. All participant contributions are projected to a future value at the plan's normal retirement age. These future values are expressed as a percentage of current year compensation and tested with the applicable Rate Groups. Each HCE is tested as a separate Rate Group and must satisfy coverage testing limits relative to the NHCE's.

Although the testing and allocations are complicated, there is a lot of contribution flexibility in this type of plan.