How Can We Improve ADP/ACP Test Results Without Offering Safe Harbor?

Facts

My architectural firm sponsors a 401(k) plan. We have 38 architects and 2 administrative assistants. We currently provide a matching contribution to participants and, some years, a profit sharing contribution too. I'm reluctant to utilize a safe harbor design, because I really value the vesting schedule on our employer contributions to help retain my best talent, but the plan frequently fails ADP and ACP testing.

Question

Are there any options that could improve testing without having to explore safe harbor or automatic enrollment?

Answer

We've got just the thing! Before we dive in though – here's a quick refresher. The ADP and ACP tests compare the average deferral and match rates, respectively, of the highly compensated employees (HCEs) to those of the non-HCEs. If the HCEs far out-contribute the NHCEs, the testing fails, and refunds are likely for those in the HCE group. A few of the variables that can tweak testing results include:

- Who is an HCE,
- Who is an NHCE, and
- How much they defer as a percentage of their pay.

Since it sounds like your objective is to allow everyone to continue to contribute at their current rates, that leaves us with the option of adjusting who falls into which category – HCE versus NHCE.

Typically, there are two ways an individual can be an HCE:

- Anyone who owns more than 5% of the company in the year being reviewed or in the immediately previous year, or
- Anyone who earned more than an IRS-set dollar limit from the company in the previous year, e.g. anyone who earns for than $125,000 in 2019 is an HCE in 2020.

However, it is that second bullet point that makes it possible to change up the definition of HCE – stay with us here! The so-called "top paid group election" is an alternative to the traditional means of defining HCEs. It allows you as the plan sponsor to limit those who are HCEs based on compensation to only the highest paid 20% of participants. Those who meet the 5% ownership test are always HCEs, regardless of pay. All others, even those participants who meet or exceed the compensation threshold are in the non-HCE group.

How does this help? Let's look at your architectural firm. Assuming you pay each of the architects more than $125,000 in compensation, you have 38 HCEs and only 2 non-HCEs. If most or all of the HCEs are deferring at higher rates, this created a very lopsided test result. With the top paid group election, the mix changes so that there are only 8 HCEs (40 participants x 20%) and 32 non-HCEs. This assumes that the owners are also among the eight highest paid people in the firm.

What does this mean for testing purposes? The 8 HCEs are still likely among those who are maximizing their deferrals, but you have now shifted 30 others who are deferring at higher rates into the non-HCE group. That boosts the non-HCE average which, in turn, provides a higher deferral limit for those who remain in the HCE group. This can be extremely effective for improving test results for a firm with many high earners and high levels of contributions.

While the top paid group election can be a powerful tool to improve testing without any major impact to either the participants or the firm's bottom line, there are (like always) a few important caveats to keep in mind. First, if the 20% calculation we laid out above seemed a little too straightforward you've clearly been reading these articles for a while. Certain short-service and terminated employees are disregarded in the calculation.

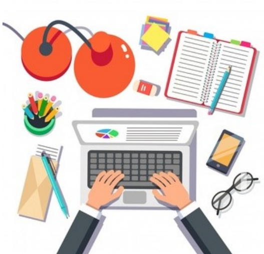
Second, the top paid group election doesn't always improve *all* results. Certain types of profit sharing allocation methods require the company to provide a minimum level of benefit to all non-HCEs; whereas, HCEs are not subject to such a requirement. In the above scenario, you now have 32 participants entitled to that minimum benefit instead of just two. Then again, providing more benefits to more non-HCEs could allow the HCEs to receive benefits that are that much higher. It really comes down to what the firm's objective is and running some projections that look at the entire picture and not just the ADP test results.

The moral of the story here is that it's important to take a detailed review of all the intended and unintended consequences of making the election. Finally, one more note to consider – implementing the top paid group election requires a plan amendment, and it must be adopted by the end of the year for which it will apply.

Whether designing a building or a great retirement plan, detailed reviews and pre-planning are critical for successful outcomes. If you think the top paid group might benefit your plan, let us know. We can run the projections and help you understand your options to determine which design is the right one for your firm.

Related Resources

- Nondiscrimination Testing Overview



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