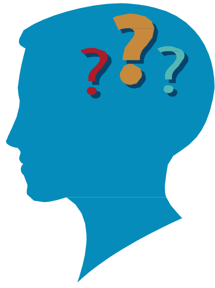

STRATEGIC PLAN DESIGN: SMART SOLUTIONS FOR OVERCOMING FAILED ADP/ACP TESTING

Q&A FROM THE JULY 19, 2018 WEBINAR

Does Newport Group offer combined qualified and non-qualified plan solutions that can provide a seamless approach for plan sponsors and their participants?

Yes. As a first step, Newport Group can build or take over a plan sponsor's 401(k), and then either take over the non-qualified plan (if there is one), or build a non-qualified plan on top of the 401(k). Among the advantages for participants: a single portal sign on and one place to review 401(k) and non-qualified plan information. If you are interested in further information, feel free to reach out to our sales team here.

What are some other options available to organizations that are not interested in Safe Harbor as a way to avoid plan failures?

Newport Group can model the cost of various solutions for plan sponsors, including Safe Harbor and non-qualified plans to help them determine the best course of action for their organization.

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Another alternative for sponsors is to remove highly-compensated employees (HCEs) from the organization's 401(k) plan. If a sponsor were to do that, they would need to provide HCEs with an alternative. There are quite a few alternatives available, and Newport Group can provide sponsors with further details about each. Contact our sales team for additional information and customized guidance on plan provision options.

When a HCE leaves employment does that help the Actual Deferral Percentage/Actual Contribution Percentage (ADP/ACP) test immediately or does it take a couple of years after HCE termination?

The answer is: it depends. There is an immediate impact because the HCE's deferral percentage is for the current year. If the HCE is employed during the year, the deferral percentage will impact the ADP/ACP test that year. For the following year, however, when we are calculating the test and that HCE is no longer employed, sponsors will see the effect of the HCE percentage not included in the ADP/ACP testing calculation.

In the current year, if an HCE is deferring to zero or something low, he or she may be helping a sponsor's highly-compensated employee deferral rate by bringing it down. But if a sponsor has the opposite scenario—an HCE maximizing deferrals so that his or her deferral percentage is quite high—then in the year the HCE is included, they may be creating issues. In this case, the HCE could be causing the plan to fail and may end up forcing refunds to other plan participants.

In the end, it depends on the HCE's participation rate in their last year. Sponsors will see the effect of terminating the HCE in the following year when the overall rate for HCEs changes due to one fewer employee and subtracting whatever their deferral percentage was from the average.

My client has a long-term incentive compensation plan (LTIC), and a restricted stock units plan (RSU). How would that work with a non-qualified plan?

LTICs and RSUs are typically issued or granted on an annual basis with a vesting schedule over three or four years. This is known as a rolling vesting schedule. The problem is when a participant vests in either an LTIC or RSU, they pay taxes—and usually, it's a high dollar amount. For RSUs, if the company stock does well, whenever the vesting point occurs, they get hit with a huge tax bill. One of the things Newport Group can offer under a deferred compensation plan is the ability to defer the long-term incentive, either concurrent with the grant or 12 months prior to vesting. We can do the same thing with a restricted stock plan.

How can sponsors can suspend or end Safe Harbor matching without running into issues?

If a sponsor has a Safe Harbor plan that is terminating—in conjunction with an acquisition, merger or something similar—they can maintain Safe Harbor status even for that short year. They still have to do the contributions, but no other tests kick in under that type of an arrangement. However, if the Safe Harbor feature is being suspended for other reasons—they want to terminate the plan, for example— additional steps needed. The sponsor has to give notice that the contribution is ending, and notice has to be given at least 30 days in advance. They need to contribute the amount of the Safe Harbor contribution up through the date of the notice. So, it's a timing issue. They have to make sure that they have a date for stopping the Safe Harbor, give notice at least 30 days prior to that date, and amend the plan to say that they are no longer going offer the Safe Harbor plan. If the plan sponsor takes these steps, then the current year testing is in effect and they have to go back to doing an ABT test using the current year testing.

How many employees do you recommend an organization has before considering a qualified automatic contribution arrangement (QACA)?

QACA is not tied to the number of employees so much as to the level of participation in the plan. This goes for any of the automatic contribution arrangements or the Safe Harbor. As we talked about during the presentation, you have to look at the demographics of a company—levels of participation, employee turnover, etc. It is based on the level of current participation in a plan and how that will be affected, versus a certain number of employees. That is because it can look different all over the board depending on what a company's HCEs are doing compared to what the non-highly compensated employee (NHCE) group is doing. For example, if you have a plan with low participation, that's going to drive up employer contribution expense as a QACA match (if a match is used). If the plan already has a high percentage of NHCE employees participating, then the QACA match may be a better option than the traditional Safe Harbor formula. That is because, in QACA, that formula is slightly less. Clients need to consider the participation level, rather than employee count, to help make these decisions. And that's something that Newport Group can do—look at the different fact patterns within the company—to help identify what is the best arrangement to put in place. Is it a Safe Harbor? Is it an automatic contribution arrangement? Or is it the combination of both, in this case with the QACA? Or is it, "let's just leave that all out of the way and go to the non-qualified plan." These are all things that we can factor in, along with the fact patterns to analyze the specifics and identify what might work best for the sponsor.

Does the non-elective contribution (NEC) have to go to all NHCEs, or can you select the NHCEs to receive the NEC?

The qualified non-elective contribution (QNEC) must be allocated under a definite allocation formula and must be allowed in the plan document. The employer cannot "pick and choose" which employees will receive the QNEC allocation and be able to use these contributions to pass the ADP test.

This was allowed at one time but the rules changed and significantly limited methods effective for plan years beginning after January 1, 2006. A typical plan design is for QNECs to be allocated to all eligible employees who are NHCs. By limiting the allocation to NHCs, the contributions raise only the percentages of the NHCs and passing the test is made easier.

The allocation formula usually is pro rata based on compensation and all eligible NHC employees receive a uniform allocation rate. As an alternative, the formula in the plan may provide a uniform dollar amount for each eligible NHCs. The allocation of QNECs also may be conditioned on an NHC's completion of a service requirement, such as a minimum number of hours of service for the plan year (e.g., 1,000 hours) and/or the requirement to be employed by the employer on the last day of the plan year.

Can you have a safe harbor match equal to 100% on the first 4% then 50% on the next 2%?

Yes, an enhanced formula satisfies the ADP safe harbor contribution requirement so long as the matching contribution at each level of deferral is no less than the matching contribution determined under the basic formula. See IRC §401(k)(12)(B)(iii), Treas. Reg. §1.401(k)-3(c)(3) and Notice 98-52. To test whether a formula is satisfactory, look to the level of the match that is made on each level of deferral up to 5% of compensation, and compare the matching contribution under the formula with the matching contribution that would be made at that deferral level under the prescribed formula. In addition, the rate of match cannot increase as the rate of deferral increases. For the match formula to be used to satisfy the ACP testing requirements, the matchable contributions are capped at 6%.

What are some plan design changes that could help with testing for groups with large, variable-hour employees?

One good plan design for a plan with a large number of hourly employees/ would be a Safe Harbor plan with a basic match. Many employees will not participate, therefore keeping the ER match commitment low. Otherwise, excluding the HCE from the 401(k) plan completely and adding a non-qualified plan to cover the HCE could be a good option.

What are ways to promote a plan that is always on the cusp of pass/fail?

One possible solution is offering a matching contribution, which typically helps participation. If a plan already has that feature, then an automatic contribution arrangement (ACA) would force employees into the plan.

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Can make-up contributions for a 55 year old (50% owner) be used instead of normal contributions to bypass failing the ADP/ACP test?

For a deferral to be considered a catch up contribution, a limit has to be met. The limit is either the maximum annual deferral limit ($18,500 for 2018), plan imposed limit, ADP refund or maximum annual additions (415), which is $55,000 or $61,000 with catch. You cannot just count the first deferrals in the plan as catch up.

Any strategies or special testing rules that apply for union employees that are deemed HCEs?

There are special rules for this. One rule provides for disaggregated ADP testing of the union employees (see #1 below). Another rule deals with 401(k) arrangements covering union employees that fail to satisfy the ADP test (see #2 below). A third rule deems the union employees to meet the ACP test. The regulations apply these rules to a plan that benefits employees who are covered by a collective bargaining agreement.

If a 401(k) plan covers both union employees and non-union employees, the plan is treated as comprising separate plans: (1) one plan that covers the union employees, and (2) one plan that covers the non-union employees. Separate ADP tests must be applied to the non-union portion and union portion of the plan. This is because the disaggregation rules under the coverage testing regulations. When a 401(k) arrangement fails to satisfy the ADP test and corrective action is not taken on a timely basis, the plan is treated as having a non-qualified cash or deferred arrangement. Under a non-qualified cash or deferred arrangement, the elective deferrals of the employees are not excludable from income, so the employees are taxed on their deferrals.

Find Out More:

To learn more about turning obstacles into opportunities,
contact your Newport Group representative.

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