Nondiscriminatory Matching Contributions: More Than Simply ACP Testing

Actual contribution percentage (ACP) testing is only one part of nondiscrimination testing of matching contributions, whether in a 401(k) or 403(b) plan. Other parts include coverage testing and benefits, rights, and features testing of matching contributions. Plan sponsors and their third-party plan administrators need to clearly communicate information necessary for ACP testing, as well as for coverage and other nondiscrimination testing of matching contributions, such as controlled group information about plans, employers and employees, and exactly what compensation is used for what purposes.

by Daniel P. Schwallie, Ph.D. | Aon Hewitt

“...my recordkeeper takes care of the plan’s nondiscrimination testing.” How often has that response been made to the question of who is doing nondiscrimination testing of an employer’s 401(k) or 403(b) plans! Sometimes, it is even true.

Often, all the response really means is that the recordkeeper is doing the ADP (actual deferral percentage) test, in the case of 401(k) plans, and the ACP (actual contribution percentage) test, in the case of 401(k) and 403(b) plans.¹ The disconnect between the question and the response typically is due to a lack of communication and, perhaps, understanding among the plan sponsor, the recordkeeper and other plan advisors. By way of example, this article focuses on matching contributions, as matching contributions apply to both 403(b) and 401(k) plans and often seem to give rise to the defined contribution plan testing considerations described further below. Of course, some plans are exempt from ACP testing because they satisfy an ACP “safe harbor” design permitted by the Internal Revenue Code (Code) and applicable regulations. Nevertheless, even ACP safe harbor plans must satisfy their own version of nondiscrimination requirements, which are not described in this article.

What Is the ACP Test?

The purpose of the ACP test is to prevent matching contributions and aftertax (non-Roth) contributions from disproportionately favoring highly compensated employees (HCEs). For purposes of the ACP test and other nondiscrimination tests, HCEs are employees whose compensation for the preceding year exceeds an inflation-adjusted amount. For example, an HCE for 2012 has compensation exceeding $110,000 during 2011.² Compensation for purposes of deter-
mining who is an HCE generally is one of the definitions of total compensation defined later in this article. An employee who is not an HCE is a non-highly compensated employee (NHCE).

The essence of the ACP test is to compare each year the average matching contribution as a percentage of 414(s) compensation (defined later in this article) for all HCEs against the average for all NHCEs. If non-Roth aftertax contributions are provided for under the plan, they must be included with the matching contributions in the ACP testing.

The first step in the ACP test is to calculate a contribution percentage (CP) for each employee eligible to participate in the matching program (and each employee eligible to make non-Roth aftertax contributions, if the plan permits them), even if the employee makes no elective deferrals or non-Roth aftertax contributions, expressed as the following formula:

\[ CP = \frac{100\% \times (\text{matching contributions} + \text{non-Roth aftertax contributions})}{\text{414(s) compensation}} \]

The next step is for an average of the CPs to be calculated separately for the HCEs and the NHCEs as follows:

- HCE ACP = sum of CPs for all eligible HCEs ÷ total number of all eligible HCEs
- NHCE ACP = sum of CPs for all eligible NHCEs ÷ total number of all eligible NHCEs

Then the ACP test is satisfied only if either:

- HCE ACP < 1.25 × NHCE ACP; or
- HCE ACP - NHCE ACP <2 percentage points \text{ and } HCE ACP < 2 × NHCE ACP

Correction of an ACP test failure generally requires a distribution of a portion of matching contributions (and, if provided for under the plan, non-Roth aftertax contributions) to HCEs or an additional vested contribution on behalf of NHCEs until the ACP test is passed. To the extent that matching contributions that would need to be distributed are not vested, they are forfeited instead. Excise taxes and additional penalties may apply to the plan sponsor if corrections are not timely made.

A (Not Uncommon) Story

A brief story will quickly illustrate several of the considerations that arise in conjunction with ACP testing. Some number of years ago, an employer had about a dozen 401(k) plans with matching contributions. This employer had a main 401(k) plan for most of its employees but would typically “park” acquired businesses in prototype 401(k) plans with a recordkeeper until a determination was made to move the acquired group of employees into the main plan. Sometimes the employer would spin off an acquired entity before such a determination was made. Sometimes the acquired entity remained in a prototype plan because the entity was not profitable enough to move into the main plan; the main plan provided benefits typically better than the prototype plan of the entity, and any entity whose employees became covered by the main plan would be required to contribute to the main plan on their behalf. However, every employee was covered by a 401(k) plan, either the main plan or one of the prototype plans, and anyone who made 401(k) deferrals was also eligible to receive a matching contribution.

During an acquisition, it was determined to move the acquired group of employees directly into the main plan, and the question arose of how this would affect nondiscrimination testing. The testing of the main plan was done by its recordkeeper, and the testing of the prototype plans was done by the recordkeeper that provided the prototype plans. The recordkeeper for the main plan had obtained employee data for the employer’s entire controlled group of entities from the plan’s actuary, who had been doing the nondiscrimination testing of the employer’s defined benefit plans. The recordkeeper for the prototype plans had not. It turned out that the prototype plan recordkeeper had been treating each entity as if it were the only employer, i.e., as if each entity were a separate controlled group independent of the employer that had acquired the entity. This brings us to our first point about nondiscrimination testing of matching contributions being more than simply ACP testing.

Coverage Testing of Matching Contributions

Code Section 410(b) and the related Treasury regulations require that the group of employees eligible for matching contributions under a plan not significantly discriminate in favor of HCEs. The basic purpose of coverage testing in the context of matching contributions is to prevent an employer
from providing matching contributions in a plan mostly (or only) to HCEs. To show that this plan coverage requirement is satisfied, the group of employees must pass either a ratio percentage test or an average benefit test. Both of these tests require employee data for all employers that are part of the same controlled group, which generally means employers that share at least 80% ownership or control among them. Failing either test can be costly, either in terms of making required corrections or paying penalties to the Internal Revenue Service (IRS), or both.

### Ratio Percentage Test

The ratio percentage test is strictly a head count test of HCEs and NHCEs. The percentage of all NHCEs in the same controlled group of employers that are eligible for matching contributions under the plan must be at least 70% of the percentage of all HCEs in the same controlled group who are eligible for matching contributions under the plan. An employee is considered eligible for matching contributions under the plan if the employee would receive a match on match-eligible deferrals (or match-eligible aftertax contributions), regardless of whether the employee actually makes match-eligible deferrals (or match-eligible aftertax contributions).

Written as a formula, the ratio percentage test requires the following:

\[
\text{NHCE\%} \div \text{HCE\%} \geq 0.70, \text{ where} \\
\text{NHCE\%} = \frac{\text{NHCEs eligible under the plan}}{\text{All NHCEs in controlled group}} \\
\text{and} \\
\text{HCE\%} = \frac{\text{HCEs eligible under the plan}}{\text{All HCEs in controlled group}}
\]

As an example, consider an employer with three plans (A, B and C) that, together, cover 100% of all the employer’s employees. The percentage of HCEs and NHCEs covered by each plan and the resulting ratio percentage test results are shown in Table I.

Provided that certain conditions are met, two or more plans of an employer can be combined for purposes of the ratio percentage test. In the example above, if Plan A can be combined with either Plan B or Plan C, the combined plan will pass the ratio percentage test even though Plan A fails on its own.

### Average Benefit Test

If a plan cannot pass the ratio percentage test, it may be able to pass the average benefit test. The average benefit test requires calculating a benefit percentage for each of the employees in the employer’s controlled group, but is not needed if the plan can pass the ratio percentage test. The average benefit test has three parts consisting of a reasonable classification test, a nondiscriminatory classification test and an average benefit percentage test.

<table>
<thead>
<tr>
<th>Plan</th>
<th>HCEs Covered</th>
<th>NHCEs Covered</th>
<th>Ratio Percentage</th>
<th>Test Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>60%</td>
<td>30%</td>
<td>50%</td>
<td>Fail</td>
</tr>
<tr>
<td>B</td>
<td>20%</td>
<td>40%</td>
<td>200%</td>
<td>Pass</td>
</tr>
<tr>
<td>C</td>
<td>20%</td>
<td>30%</td>
<td>150%</td>
<td>Pass</td>
</tr>
</tbody>
</table>
Nondiscriminatory Classification Test

The *nondiscriminatory classification test* is identical in formula to the ratio percentage test, except that different (and lower) pass percentages apply, depending on what percentage of all employees in the controlled group are NHCEs, and the nondiscriminatory classification test is only one part of the average benefit test. We will revisit the nondiscriminatory classification test for another test described below relating to matching contributions.

Average Benefit Percentage Test

The *average benefit percentage test* is a rather complex, data-intensive numerical test that compares the average of NHCE benefit percentages to the average of HCE benefit percentages. Oversimplifying, an employee's benefit percentage is the employee's benefit from all the employer's retirement plans as a percentage of the employee's compensation. A complete explanation of the average benefit percentage test is well beyond the scope of this article.

The Coverage Test Story of Our Employer

In our continuing saga, because the prototype plan recordkeeper treated each entity as a separate controlled group with its own single plan covering all employees, the recordkeeper had been reporting 100% ratio percentage test results for each prototype plan. As illustrated by the example above, when an employer (i.e., the controlled group in our saga) has more than one plan for its employees, the possibility that each plan will have 100% ratio percentage test results is extremely remote. When the plans were reexamined using controlled group employee information, several of the plans failed the ratio percentage test. The thought was then to see if the plans could be combined in some way such that combinations of the plans could pass the ratio percentage test.

One requirement for combining plans for purposes of the ratio percentage test (and for purposes of the nondiscriminatory classification test) is that the plans must have the same plan year. The main plan had a non-calendar year plan and so could not be combined with any of the prototype plans, because they each had a calendar year plan. At first, it was thought that all the prototype plans could be combined to pass the ratio percentage test. However, another requirement for combining plans is that a combination (aggregated) plan must be treated as a single plan for all purposes of nondiscrimination testing. While this would include for purposes of ACP testing of the matching contributions, a bigger concern was the fact that the matching contribution rate was not the same in each of the prototype plans. This brings us to our second point about nondiscrimination testing of matching contributions being more than simply ACP testing.

Effective Availability Test

The *effective availability test* requires that, based on all the relevant facts and circumstances, the group of employees to whom a specific rate of match is actually (effectively) available (or made available) does not substantially favor HCEs. This test is really a type of anti-abuse rule. For example, if a plan provided for aftertax contributions, but only the two top paid officers of the employer knew about that, the match on aftertax contributions would not be effectively available to a nondiscriminatory group.

Current Availability Test

The *current availability test* requires that each specific rate of match satisfy the reasonable classification test and nondiscriminatory classification test described above. Therefore, the group of employees to whom each specific rate of match is available must, under all the facts and circumstances, be reasonable and established under objective business criteria (but not by name).

Nondiscriminatory Classification Test of Matching Contribution Rates

The percentage of controlled group NHCEs for whom a specific matching rate is currently available divided by the...
percentage of controlled group HCEs for whom the specific matching rate is currently available (expressed as a percentage) must equal or exceed the applicable safe harbor percentage to pass the current availability test.

Expressed as a formula, the nondiscriminatory classification test of each matching contribution rate requires the following percentage to at least equal the applicable safe harbor percentage in Table II.

\[
\text{NHCE}\% \div \text{HCE}\% \times 100\%, \text{ where} \\
\text{NHCE}\% = \text{NHCEs for whom rate is currently available} \\
\quad \div \text{All NHCEs in controlled group} \\
\text{and} \\
\text{HCE}\% = \text{HCEs for whom rate is currently available} \\
\quad \div \text{All HCEs in controlled group}
\]

Alternatively, if the percentage described by the formula above exceeds the applicable unsafe harbor percentage in Table II, the matching rate would pass the nondiscriminatory classification test, provided that IRS finds, based on all the relevant facts and circumstances, that the classification is nondiscriminatory.\textsuperscript{11} The unsafe harbor pass percentages are ten percentage points lower than the corresponding safe harbor pass percentages, but never less than 20%.

Permitted pass percentages are a function of what percentage of all employees in the controlled group are NHCEs, as illustrated by Table II.

Note that IRS Publication 7334, as revised June 2011, which is used by IRS to “identify major problems that relate to plans providing for employee and/or matching contributions,” states that “some formulas for employee or matching contributions may be, per se, discriminatory, e.g., where the availability of employee or matching contributions is limited to employees with compensation in excess of the integration level under the plan.”\textsuperscript{12}

The Current Availability Test Story of Our Employer

When we last left the saga of our employer, the thought was to see if the plans could be combined in some way such that combinations of the plans could pass the ratio percentage test. At first, it was thought that all the prototype plans could be combined to pass the ratio percentage test. However, the matching contribution rate was not the same in each of the prototype plans. Fortunately for our employer, it was possible to group those plans that did have the same matching rate such that the combined plans each passed both the ratio percentage test for coverage of each combined plan and the nondiscriminatory classification test for current availability for each matching rate. If that had not been possible, corrective actions would have needed to be taken for each plan that did not pass the current availability test, which might have included changing the design of various plans, making additional contributions and submitting a voluntary compliance program application under the IRS Employee Plans Compliance Resolution System, along with paying a compliance fee.

A Single Plan of a Single Employer May Have More Than One Matching Rate to Test

Although the story of our employer is not unique, we need not dwell on such a complicated situation involving many dif-
ferent plans within a controlled group of multiple employers, because there are also single employers that have more than one matching rate (or set of matching rates) within the same plan that apply to different groups of employees. For example, a plan may provide different matching rates to different business unit employees in the same plan. Also, while more common for 403(b) plans than 401(k) plans, some plans provide a different matching rate depending upon the participant’s age, service or a combination of both, such that the matching rate increases with age and/or service. Such a plan might provide a 50% matching rate to participants with fewer than ten years of service, a 100% matching rate to participants with more than ten but fewer than 15 years of service, and a 150% matching rate to participants with at least 15 years of service. Each of these different matching rates would need to pass a nondiscriminatory classification test with respect to the group of employees to whom each rate is currently available based on their current service. Current availability testing of matching rates is in addition to, and not in place of, ACP testing of the entire plan. This brings us to our third point about nondiscrimination testing of matching contributions being more than simply ACP testing or, perhaps more correctly in this instance, being more than simply ACP testing.

Special ACP Test Rule for Match Rate Greater Than 100%

The regulations under Code Section 401(m) issued in 2004 and effective for plan years beginning after 2005 added a new rule applicable to those plans that provide a matching contribution in excess of 100% of elective deferrals (including Roth contributions) of an NHCE. Although the apparent intent of this rule is to prevent a plan sponsor from skewing the ACP test results by simply providing a large matching contribution to a small number of NHCEs, it is possible that the rule could have an adverse impact on ACP testing for some plans that more generally provide a matching contribution in excess of 100% of elective deferrals.

Under this special rule, a matching contribution with respect to an elective deferral of an NHCE cannot be taken into account for purposes of the ACP test (i.e., must be excluded from the ACP test) to the extent it exceeds the greatest of the following three amounts:

1. 5% of the NHCE’s compensation;
2. The NHCE’s elective deferrals for the year; or
3. Twice the plan’s representative matching rate times the NHCE’s elective deferrals for the year.

Note that a corresponding rule applies with respect to matching contributions on aftertax (non-Roth) contributions and with respect to matching contributions for plans that provide matching contributions on the sum of elective deferrals and aftertax contributions. Because this rule limits only matching contributions of NHCEs (and not of HCEs) that can be used in calculating the ACP test, this rule can only worsen the ACP test results (possibly requiring more or larger match distributions or forfeitures among HCEs), but only if matching contributions exceed the largest of (1), (2) or (3) with respect to any of the NHCEs.

The plan’s representative matching rate is defined as the lowest matching rate for any eligible NHCE among a group of NHCEs consisting of half of all eligible NHCEs in the plan for the plan year who make elective deferrals for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals for the plan year). Generally, the lowest matching rate from the half of all eligible NHCEs with the largest matching rates (i.e., the median matching rate) would provide the best result for item (3) of the three amounts listed above.

For purposes of this special rule, the matching rate is not necessarily the same as the matching rate (or rates) defined in the plan, but rather the matching rate is defined as the matching contributions made for the NHCE for the plan year divided by the NHCE’s elective deferrals for the plan year. However, if this matching rate is not the same for all levels of elective deferrals for an NHCE, the NHCE’s matching rate is determined assuming that the NHCE’s elective deferrals are equal to 6% of compensation. This brings us to our fourth point about nondiscrimination testing of matching contributions being more than simply ACP testing.

Compensation Used for ACP Testing Must Be Nondiscriminatory

Compensation for purposes of the ACP test must consist of safe harbor compensation as defined by regulations...
Ensuring a plan’s matching contributions are nondiscriminatory means more than just doing the ACP test. It also involves ensuring that matching contributions are offered to a group of employees that does not significantly favor HCEs (by doing coverage testing) and that each rate of matching contributions available to a group of employees does not significantly favor HCEs (by doing benefits, rights and features testing).

1. A general definition of total compensation, prescribed by regulations
2. A simplified general definition that excludes certain taxable items otherwise included in the general definition
3. Wages for purposes of income tax withholding plus pretax amounts under a cafeteria plan, 403(b), 401(k) or 457(b) plan, or qualified transportation fringe benefit plan
4. Form W-2, Box 1, compensation plus pretax amounts under a cafeteria plan, 403(b), 401(k) or 457(b) plan, or qualified transportation fringe benefit plan.

While the included and excluded items of compensation vary somewhat among these four definitions of total compensation, the differences generally are not substantial in dollar terms.

**Alternative Safe Harbor 414(s) Compensation Definitions**

An alternative safe harbor 414(s) safe harbor compensation definition is any of the preceding four definitions of total compensation reduced by all of the following pay items, even if includable in gross income:

- Reimbursements or other expense allowances
- Fringe benefits (cash and noncash)
- Moving expenses
- Deferred compensation
- Welfare benefits.

Like the total compensation definitions, an alternative safe harbor definition can be used when a 414(s) definition of compensation is required, such as for ACP testing.
**Reduced Safe Harbor 414(s) Compensation Definitions**

A reduced safe harbor 414(s) safe harbor compensation definition is any of the four total compensation safe harbor or any of the alternative safe harbor compensation definitions reduced by all of the following pretax amounts:

- Code Section 125 (cafeteria plan) pretax contributions (such as participant health insurance premiums and contributions to flexible spending accounts)
- Amounts excluded from a participant’s gross income for Code Section 132(f) qualified transportation fringe benefits
- Elective deferrals to a 403(b), 401(k) or 457(b) plan, a simplified employee pension, or a simple retirement account.

A reduced safe harbor definition can be used when a 414(s) definition of compensation is required.

**HCE-Reduction-Only Safe Harbor 414(s) Compensation Definitions**

Any of the preceding 414(s) safe harbor compensation definitions (total compensation, alternative safe harbor or reduced safe harbor) can be modified to exclude any portion of the compensation received by some (or all) HCEs, but without any similar reduction for any NHCEs, and remain a 414(s) safe harbor compensation definition for ACP testing and other purposes.

**Alternative 414(s) Non-Safe Harbor Compensation**

An alternative 414(s) non-safe harbor compensation definition is a definition of compensation that:

- Does not by design favor HCEs
- Satisfies certain requirements to be considered reasonable
- Satisfies a mathematical pay inclusion test.

Such an alternative non-safe harbor definition satisfies Code Section 414(s) and can be used when a 414(s) definition of compensation is required, such as for ACP testing. This is different than a compensation definition that is not safe harbor and does not satisfy 414(s), which cannot be used when a 414(s) definition of compensation is required, such as for ACP testing. Thus, it is possible for a plan to use a plan's definition of compensation for purposes of calculating matching contributions that cannot also be used to ACP test those matching contributions.

The first requirement, that the compensation definition must not by design favor HCEs, is really an anti-abuse rule, based on facts and circumstances. For example, a definition of pay that only included $10,000 of pay plus any pay in excess of the minimum amount to be considered an HCE (e.g., $110,000 in 2011) would by design favor HCEs.

**Reasonable Compensation**

A compensation definition is reasonable for purposes of 414(s) if it is one of the safe harbor definitions (total compensation, alternative safe harbor, reduced safe harbor or HCE-reduction-only safe harbor) modified to exclude, on a consistent basis, all or any portion of irregular or additional compensation (such as overtime, shift differentials, bonuses, pretax contributions and 403(b) elective deferrals) or any one or more of the items permitted to be excluded to obtain an alternative safe harbor 414(s) safe harbor compensation definition described above. A reasonable definition of compensation is also permitted to include, on a consistent basis, all or any portion of the items excluded to obtain a reduced safe harbor 414(s) compensation definition described above.

**Pay Inclusion Test**

The purpose of the pay inclusion test is to ensure that the non-safe harbor definition to be used for nondiscrimination testing does not include disproportionately more compensation for HCEs than for NHCEs, which could cause nondiscrimination test results to favor HCEs. For instance, in the ACP test, using a definition of compensation that generally includes more of total pay for HCEs than NHCEs would cause the contribution percentages for HCEs to be smaller and make the ACP test result more likely to pass.

The first step of the pay inclusion test is to calculate an inclusion percentage for each participant by dividing the non-safe harbor compensation for the participant by the participant’s total compensation, as defined by one of the total compensation 414(s) safe harbor definitions described above. The non-safe harbor 414(s) compensation definition cannot be larger than the total compensation 414(s) safe
harbor compensation definition. For purposes of the ACP test, an inclusion percentage would be calculated for each employee eligible for matching contributions under the plan, i.e., each employee who would receive a match on match-eligible deferrals (or match-eligible aftertax contributions), regardless of whether the employee actually makes match-eligible deferrals (or match-eligible aftertax contributions).

The second step of the pay inclusion test is to separate the participants into HCEs and NHCEs, then average the inclusion percentages separately for the HCEs and NHCEs. To pass the pay inclusion test, the average HCE inclusion percentage must not exceed the average NHCE inclusion percentage by more than a de minimis amount, based on all the relevant facts and circumstances. IRS has not provided a numerical test of what is meant by a de minimis amount, as it is intended to be an anti-abuse rule like most other facts and circumstances tests. Of course, the pay inclusion test is satisfied if the average HCE inclusion percentage is less than the average NHCE inclusion percentage.

A Quick Recap Summary

Ensuring a plan’s matching contributions are nondiscriminatory means more than just doing the ACP test. It also involves ensuring that matching contributions are offered to a group of employees that does not significantly favor HCEs (by doing coverage testing) and that each rate of matching contributions available to a group of employees does not significantly favor HCEs (by doing benefits, rights and features testing). Further, compensation used for ACP testing must be nondiscriminatory compensation so that the ACP test results are not skewed in favor of HCEs. And those plans that provide matching contributions in excess of 100% of elective deferrals must apply a special rule that could limit compensation of participants who are not HCEs for purposes of the ACP test, thereby making the test harder to pass. Perhaps most importantly, employers should communicate clearly with their third-party plan administrators, their other plan advisors and other employers in their controlled group to ensure that all relevant circumstances are known to all involved in testing, all required tests are being done, and complete and correct data (including proper compensation) is provided.

Endnotes

1. Note that 403(b) plans of public schools, including colleges and universities, are not subject to ACP testing, coverage testing or Code Section 401(a)(4) nondiscrimination testing.
2. This is an oversimplification, as certain optional rules can be applied in determining who HCEs are, and certain other rules must be applied.
3. Code Section 414(q) and the corresponding regulations provide that HCE status is based on compensation as defined by Code Section 415(c)(3). The 414(q) regulations have not been amended since 1994. Effective for plan years beginning after 2001, Code Section 415(c)(3)(E) was added, which provides that includible compensation, as defined by Code Section 403(b)(3), is 415(c)(3) compensation for purposes of a 403(b) plan. However, Treasury regulation Section 1.403(b)-5(a)(3), issued in 2007 and effective January 1, 2009, states that compliance with coverage, ACP and other nondiscrimination testing “is tested using compensation as defined in section 414(a) (and without regard to section 415(c)(3)(E))”. Although the 403(b) regulations do not expressly cross reference the rules for determining HCEs under 414(q) and the corresponding regulations, it would be both odd and difficult to use two different definitions of compensation for determining HCEs in a situation where the testing of both 403(b) and 401(k) or other tax-qualified plans under Code Section 401(a) had to use two different definitions of compensation (i.e., had to use “includible compensation” for purposes of determining HCEs for purposes of the 403(b) plan and one of the four total compensation definitions of compensation for purposes of determining HCEs for purposes of other, 401(a) tax-qualified plans). Given the timing of the statutory and regulatory changes, the limited differences between includible compensation and the four total compensation definitions, the general framework for nondiscrimination testing (in that the determination of HCEs is most applicable to nondiscrimination testing), and for purposes of consistency, many, if not most, practitioners appear to use one of the four definitions of total compensation provided by the Code Section 415 regulations to determine HCEs for 403(b) plans. Guidance from IRS is not entirely clear on this point, but perhaps the forthcoming preapproved plan document program for 403(b) plans will provide more clarity.
4. There is not a separate ACP test for non-Roth aftertax contributions unless the plan satisfies an ACP safe harbor design, in which case the matching contributions are not ACP tested, but the aftertax contributions still must be ACP tested. The applicable regulations permit the matching contributions to be included or excluded when ACP testing the aftertax contributions in a plan that satisfies an ACP safe harbor design. It is often advantageous to include the matching contributions when the aftertax contributions cannot pass the ACP test on their own.
5. The mechanics of the distribution are not detailed in this article.
6. The forfeiture and distribution process is more complex than suggested here and is data intensive with specified deadlines.
7. Similarly, a plan that permits after-tax contributions would need to separately coverage-test those contributions. Likewise, coverage testing of profit sharing or other nonelective, nonmatching employer contributions provided under a 401(k) or 403(b) plan would be required. And a 401(k) plan would need to cover-test elective deferrals, but a 403(b) plan would not, 403(b) elective deferrals are subject to a separate universal availability rule.
8. Certain employees are excludable for purposes of coverage and nondiscrimination testing. For example, collectively bargained employees are generally excludable, although not from actual deferral percentage (ADP) testing.
9. In certain limited circumstances, the 70% pass criterion may need to be increased slightly.
10. The conditions for combining plans are the requirements for “permissive aggregation” under Code Section 410(b), such as having the same plan year and not having to be “mandatorily disaggregated” under the regulations.
11. No one particular fact is determinative, but regulations include facts such as the underlying business reason for the different matching rate
and how different the nondiscriminatory classification test percentage is from the safe harbor percentage.


13. Note that useful special rules apply for testing benefits, rights and features (such as a different matching rate) available under a plan solely to an acquired group of employees, provided the requirements of the special rules are met.

14. This article does not discuss certain 414(s) compensation definitions based on rates of pay or the application of prior-employer and imputed compensation permitted by the applicable regulations in certain circumstances.

15. For simplicity, certain technical details of these compensation definitions have not been listed here.

16. The treatment of 457(b) deferrals or simple retirement account deferrals is not completely clear. The 414(s) regulations have not been revised to reflect the statutory changes that require the listed pretax contributions to be included in 415 compensation and allow them to be excluded from 414(s) compensation. Code Section 414(s) does not express permit the exclusion of 457(b) deferrals, but the regulations under 414(s) do. Code Section 414(s) does not expressly permit the exclusion of simple retirement account deferrals either, but their exclusion would be consistent with the treatment of the other elective deferrals.

17. For this reason, a definition that includes employee deferrals to a nonqualified retirement plan (other than employee deferrals to a 457(b) plan) does not satisfy 414(s).

18. Instead of calculating individual inclusion percentages, an employer can use the other reasonable method to determine an average inclusion percentage for either or both groups (HCEs and NHCEs). The 414(s) regulations allow testing to be based on an aggregate inclusion percentage equal to the aggregate amount of compensation included under the non-safe harbor definition for all employees in the group divided by the aggregate amount of total compensation for employees in that group. This method is available only if it is not reasonably expected to vary significantly from the average percentage produced by using the individual percentage method.

19. While not directly relevant, some practitioners have referred to the spin-off and merger rules of Code Section 414(l), where the term de minimis has been defined by regulations to mean 3%. Other practitioners, taking a more conservative approach, have concluded that employers should proceed cautiously where the HCE average exceeds the NHCE average by any amount.

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