Components of Defined Contribution Plan Compliance Testing

Plans must be tested each year to ensure that they are compliant with the laws governing retirement plans.

Winter 2024

To understand the testing performed for your plan, it may be helpful to review some of the terms that are commonly used. First, let's examine how your plan's noteworthy individuals are identified.

Highly Compensated Employees (HCE): There are two factors that determine which employees are HCEs for a plan year:

- Ownership: An employee who owns more than 5% of the company in a plan year, or the year preceding it, is an HCE. A spouse, child, parent, or grandparent who participates in the plan will likewise be considered an HCE due to family attribution rules.
- Compensation: An employee is considered an HCE in a plan year based on their earnings the preceding year. An employee is an HCE for 2023 if they earned at least $135,000 in 2022; for 2024, the employee must have earned at least $150,000 in 2023. Plan document provisions may further limit this definition to the top 20% of earners.

Key Employees: There are three factors that determine which employees are considered key employees:

- Ownership: An employee who owns more than 5% of the company in a plan year, or the year preceding it, is a key employee. A spouse, child, parent, or grandparent who participates in the plan will likewise be considered a key employee.
- Owner compensation: An employee who owns more than 1% of the company and earned more than $150,000 in the prior plan year is a key employee.
- Officer compensation: An officer of the company is considered key in a plan year based on their earnings the preceding year. In 2023, the officer must have earned at least $200,000 in 2022; for 2024, the officer must have earned at least $215,000 in 2023.

Now that these individuals have been categorized, let's explore some of tests that might be performed on your plan:

Deferral testing: The average deferral percentage for all highly compensated employees (HCE) is compared to the average deferral percentage for all non-highly compensated employees (NHCE) to ensure the gap between the two groups is not too wide. If this test fails, there are several methods to correct the test, including refunding deferrals and earnings for HCEs or making contributions for the NHCEs. This test is known as the Actual Deferral Percentage (ADP) test. Safe harbor 401(k) plans are designed to pass the ADP test.

Match testing: This form of testing is similar to deferral testing but compares employer match instead of deferrals. This is known as the Actual Contribution Percentage (ACP) test. Safe harbor 401(k) plans are also designed to pass the ACP test.

Maximum deferral testing: An employee's deferrals cannot exceed a yearly maximum; this limit was $22,500 for 2023 and will be $23,000 for 2024. An additional $7,500 catch-up contribution can be deferred in 2023 and 2024 by participants who are at least 50 years old. If a participant has deferred more than the limit, a corrective distribution of the excess deferrals and earnings must be processed by April 15th. This limit is known as the 402(g) limit.

Maximum individual contribution testing: Similar to maximum deferral testing, the combined amount of a participant's employee and employer contributions cannot exceed a yearly maximum. This combined limit is the lesser of $66,000 for 2023, $69,000 for 2024, or the participant's total compensation. Catch-up deferral contributions are not included in this limit. This limit is known as the annual additions limit or 415 limit and is an important factor when calculating a maximum company contribution.

Maximum employer contribution: The employer's tax deduction cannot exceed 25% of compensation for plan participants. This is known as the 404 limit and is also an important factor in the calculation of a maximum company contribution.

Top-heavy testing: A plan is considered top-heavy if 60% or more of the plan assets belong to key employees. A minimum contribution may be required if the plan is top-heavy. Many safe harbor plans are designed to satisfy top-heavy testing.

When calculating a contribution for a participant or the plan, these are some of the parameters that determine the permitted amount. Understanding this terminology may provide clarity to the contribution options provided for a plan year.

Does My Plan Need an Audit?

The main determining factor in whether your plan needs an audit performed by an independent qualified public accountant is the participant count. An audit will be required if the beginning of year participant count is more than 100. For the plan year that began in 2023, there is a change to how the participants are counted. Prior to this, the count included active participants—regardless of whether or not they had an account balance—as well as terminated participants who had an account balance. Now, participants without an account balance are no longer included in the count. This is exciting news because it means that some plans who required an audit for 2022 may no longer require an audit for 2023.

For plans that hover around the 100-participant mark, there is a rule in place to help stabilize the audit requirements from year to year. The 80-120 rule states that if the participant account is from 80 to 120 participants, the plan may retain the same audit status as the previous year. In practical terms, this means that an audit is not required until the participant count reaches 121. However, once an audit is required, it continues to be required until the participant count drops to 99 or less.

In addition to participant count, the type of assets held in the plan may cause the plan to require an audit, even if the participant count is under 100. Small plans are required to have an audit unless the plan fulfills the requirements of one of these exemption waivers:

- At least 95% of the plan's assets are qualifying plan assets. This criterion is satisfied by most small plans. Qualifying plan assets include qualifying employer securities, participant loans, shares issued by a regulated financial institution, registered mutual funds, investments and annuities issued by an insurance company, and certain assets in an individual account of a participant or beneficiary.
- Less than 95% of the plan's assets are qualifying, but a fidelity bond is in effect. This fidelity bond must cover 100% of the non-qualifying assets, or provide coverage based on standard ERISA bonding rules, based on whichever value is greater.

Since a large plan audit count is now based solely on individuals with an account balance, paying out your terminated participants could help to lower your participant count. It may be time to review your cash out limit, plan assets, and the account balances of terminated participants in order to minimize the need for an accountant's audit in the future.

401(k) deferrals: Don't exceed the limit!

Excess deferrals occur when a 401(k) participant defers a greater amount than the annual IRS limit permits. The annual deferral limit was $22,500 for 2023 and $23,000 for 2024. For participants 50 years old and older, an additional $7,500 can be deferred.

When this limit is exceeded, excess deferrals and earnings need to be removed from the plan and returned to the participant. Employer matching on this excess likewise must be forfeited if it was calculated and funded during the year. Distribution of these excess funds must occur by April 15th.

Even with payroll software that limits the deferrals, there are several situations in which excess deferrals might occur:

- A participant who begins working for you may have made deferrals to a previous employer's plan during the same calendar year. After meeting any eligibility and entry requirements, they then make deferrals into your plan. Combined, these deferrals may exceed the annual limit, which is individual rather than per-plan. This error is often discovered during the preparation of the participant's tax return, and correction requests are typically received in the first few months of the year.
- When you make a change to your payroll providers or payroll software, deferral limits may be exceeded if year-to-date deferral information is not transferred correctly.
- If a participant's date of birth was input incorrectly into your payroll software, the participant may be inadvertently permitted to make a catch-up contribution, even though they haven't reached age 50.

You may be asked to perform any necessary corrections regardless of whether or not the error occurred on your watch. The best way to prevent excess deferrals is to be sure that all deferrals are tracked in your payroll and that dates of birth are correct for all participants making catch-up contributions. Most payroll software has a field to input deferrals made outside of that software; if you hire a new employee, ask for their year-to-date deferrals, and ensure that this information is given to your payroll provider or entered into your software. If you make a payroll change during the year, check the year-to-date deferrals and ensure that they are correct for each employee.

Reminder: Long-Term, Part-Time Employee Rules Effective January 1, 2024

As part of the Setting Every Community Up for Retirement Enhancement Act of 2019 (SECURE Act), part-time employees who worked at least 500 hours each year in 2021, 2022, and 2023 qualify as Long-Term, Part-Time (LTPT) employees. LTPT employees were eligible to make elective deferrals on January 1, 2024.

What happens if you missed enrolling one of these employees?

Mistakes happen. When it comes to a missed deferral opportunity, the key is to correct the failure as soon as possible. This may include withholding the proper deferrals going forward, making an employer contribution to the plan, and providing the participant with a written notice regarding the failure. If you feel as though you missed offering an employee the opportunity to defer, please contact us immediately to remedy the situation rather than waiting until the end of the plan year.

What effect does this rule have on Solo 401(k) (One-Participant) Plans?

If a plan covers a business owner (or owner and spouse) but employees have not met plan eligibility requirements in the past, the new Long-Term, Part-Time (LTPT) rules will have an impact. As the company owner is no longer the only participant, the plan will now be subject to ERISA.

The ability for the employee to defer will not necessarily impact your employer contribution and testing, but it will have an impact on the plan's filing status. This means that filing a Form 5500 or 5500-SF will be necessary, rather than filing a Form 5500-EZ. These forms require additional information to be reported, and are publicly available after filing, whereas Form 5500-EZ is not made public.

The plan will also need to be covered by a fidelity bond to protect the assets, even if part-time employees make no deferrals.

Keep the new LTPT rule in mind when hiring employees—even if not full-time—as they may have an unexpected impact on your plan. Continue to evaluate the status of your part-time employees as well so that you can be prepared for their eligibility for the plan.

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Upcoming Compliance Deadlines for Calendar-Year Plans

February 28th

IRS Form 1099-R Copy A – Deadline to submit Form 1099-R Copy A to the IRS for participants and beneficiaries who received a distribution or a deemed distribution during the prior plan year. This deadline applies to scannable paper filings. For electronic filings, the due date is April 1, 2024, as the typical March 31 deadline falls on a weekend.

March 15th

ADP/ACP Corrections - Deadline to process corrective distributions for failed ADP/ACP tests without a 10% excise tax for plans without an Eligible Automatic Contribution Arrangement (EACA).

Employer Contributions - Deadline for employer contributions for amounts to be deducted on 2023 S-corporation and partnership returns for filers with a calendar fiscal year (unless extended).

April 1st

Required Minimum Distributions - Normal deadline to distribute a required minimum distribution (RMD) for participants who attained age 72 during 2023.

April 15th

Excess Deferral Correction - Deadline to distribute salary deferral contributions plus related earnings to any participants who exceeded the IRS 402(g) limit on salary deferrals. The limits for 2023 were $22,500, or $30,000 for those age 50 and over if the plan allowed for catch-up contributions.

Employer Contributions - Deadline for employer contributions for amounts to be deducted on 2023 C-corporation and sole proprietor returns for filers with a calendar fiscal year (unless extended).