Make ADP/ACP Testing Great Again

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Agenda

- ADP/ACP Testing Overview
- Compensation
- Disaggregation
- Testing Shifting
- Testing Corrections
- Mergers and Acquisitions

Make ADP/ACP Testing Great Again

- I'm tired of tweeting about popular culture. It's time to get to the program. Let's make ADP/ACP testing great again.

— Donald J. Trump (@realDonaldTrump)

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ADP/ACP Testing

- 401(k) plans that are not ADP safe harbor are subject to the ADP test
- Determine HCE and eligible employees to be included. Compare the actual deferral ratios (ADR) of eligible NHCEs to the actual deferral ratios (ADR) of the eligible HCEs.
- EE's ADR includes pre-tax and Roth deferrals but excludes catch-up and 402(g) excesses for NHCE

ADP/ACP Testing

- Total testing deferrals are divided by testing compensation to determine each EE’s ADR
- Actual deferral percentage (ADP) is determined by averaging the ADR for each group (HCE & NHCE)
- If HCE percentage exceeds the allowable limit based on the NHCE percentage (next slide), ADP test fails

ADP/ACP Testing

- If NHCE ADP percentage is less than two percent, then allowable HCE ADP percentage is NHCE ADP multiplied by two
- If NHCE ADP percentage is two to eight percent, then allowable HCE ADP percentage is NHCE ADP plus two percent
- If NHCE ADP percentage is greater than eight percent, then allowable HCE ADP percentage is NHCE ADP multiplied by 1.25

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Example: ADP Test

HCE	Deferral	Comp	ADR
1	$18,500	$275,000	6.73%
2	$9,000	$173,000	5.20%

5.97% = HCE ADP

NHCE	Deferral	Comp	ADR
1	$15,000	$150,000	10.00%
2	$5,000	$85,000	5.88%
3	$0	$40,000	0.00%
4	$0	$1,000	0.00%

3.97% = NHCE ADP

Based on NHCE of 3.97 percent, does this plan pass the ADP test?

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ADP/ACP Testing

- 401(m) plans that are not ACP safe harbor are subject to the ACP test
- Compares the actual contribution ratios (ACR) of eligible NHCEs to the actual contribution ratios (ADR) of the eligible HCEs
- EE's ACR includes match and after-tax contributions. If an employee is not eligible for match but is eligible for after-tax, they are treated as eligible.

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ADP/ACP Testing

- Total matching and after-tax contributions are divided by testing compensation to determine each EE's ACR
- Actual contribution percentage (ACP) is determined by averaging the ACR for each group (HCE & NHCE)
- If HCE percentage exceeds the allowable limit based on the NHCE percentage, ACP test fails

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ADP/ACP Testing

- If NHCE ACP percentage is less than two percent, then allowable HCE ACP percentage is NHCE ACP multiplied by two
- If NHCE ACP percentage is two to eight percent, then allowable HCE ACP percentage is NHCE ACP plus two percent
- If NHCE ACP percentage is greater than eight percent, then allowable HCE ACP percentage is NHCE ACP multiplied by 1.25

Example: ACP Test

HCE	Match	After-Tax	Comp	ACR
1	$8,000	$22,500	$275,000	11.09%
2	$6,000	$0	$175,000	3.43%
			HCE ACP =	**7.26%**

NHCE	Match	After-Tax	Comp	ACR
1	$8,000	$0	$150,000	5.33%
2	$5,000	$0	$85,000	5.88%
3	$0	$0	$40,000	0.00%
4	$0	$0	$1,000	0.00%
			NHCE ACP =	**2.80%**

Based on NHCE of 2.80 percent, does this plan pass the ACP test?

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ADP/ACP Testing

- This ADP/ACP testing looks correct to me. No alternative facts or fake news here.

— Donald J. Trump (@realDonaldTrump)

ADP/ACP Testing

- Testing methods:
  - Prior year – ADP/ACP limit for the HCEs is based on NHCE data from the prior plan year
  - Current year – ADP/ACP limit for the HCEs is based on NHCE data from the current plan year
- Prior year is the "default" testing method
- Plan document must state which testing method is used – amendment to change

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Poll Question #1

Which testing method is more commonly utilized?

A. Prior-year testing

B. Current-year testing

Current-Year Testing Method

Pros	Cons
• Even though predictability is lost, can still get an idea of results with mid-year testing • QNEC's are practical • Match changes cause less issues with current-year testing • Less data involved for takeovers and IRS audits • Can change compensation year over year • Do not need to calculate weighted averages for plan-coverage changes	• Lose predictability of results • Once using current year testing can only go back to prior after lesser of five year of current or plan's existence

Prior-Year Testing Method

Pros	Cons
• Predictability of results • Ability to amend to current-year testing easily	• Plan sponsors do not effectively monitor the limit • If audited, IRS requires data for two plan years • Plan coverage changes require calculation of weighted averages • Takeovers – additional data to capture • Reworks for bad data may impact two plan years • Generally stuck using same compensation YOY

Prior-Year Testing Method (Continued)

Pros	Cons
	• Match stop/start could result in total ACP failure • QNEC's are usually not practical (must be deposited by the end of the actual plan year)

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Poll Question #2

Can a plan use prior-year testing for ADP testing but use current-year testing for ACP testing?

A. No

B. Yes

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COMPENSATION

Compensation

- Three types of compensation are used for qualified defined contribution
  - 415 – “gross” compensation
  - 414(s) – “test” compensation
  - Compensation for determining contributions

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Compensation

- Gross compensation (415) is used for the following:
  - Determining HCEs
  - Determining key-employee status
  - Top-heavy contributions
  - Determining 415 limits
  - The five-percent minimum allocation gateway

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Compensation

- There are four different definitions of gross (415) compensation. Refer to the plan document to see which one the plan uses
  - Statutory definition
  - Simplified version of the statutory definition
  - W-2 wages
  - Wages for income tax withholding 3401(a)

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Compensation

- Test compensation (414s) is used for the following:
  - Non-discrimination testing (ADP, ACP, 401(a)(4), and ABT)
  - Calculating SH contributions
  - Calculating contributions to a design-based SH plan (including integrated with permitted disparity)
  - Determining one-third gateway is satisfied

Compensation

- A plan may use any definition of compensation for (i.e., does not have to be 414s):
  - Calculating non-elective allocation (not a design-based SH)
  - Compensation for determining 401(k) deferrals
  - Compensation for determining employer match (not SH)

Compensation

- 1.414(s)-1(a)(2) ….”except as otherwise specified, the plan is not required to use a definition of compensation that satisfies section 414(s) in calculating the amount of contributions or benefits actually provided under the plan.”

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Compensation

- 414(s) compensation is a non-discriminatory definition of compensation.
- 414(s) safe harbors:
  - 415 compensation (any of the four definitions)
  - 415 compensation less pre-tax deferrals
  - 415 compensation with any exclusion that is applied only to some or all HCEs
  - And…

Compensation

- 415 compensation less fringe benefits (cash and noncash), reimbursements or other expense allowances, moving expenses, deferred compensation, and welfare benefits. All of these items have to be excluded for it to be considered a safe harbor definition.
- Can test on compensation from when a participant becomes eligible

Compensation

- Some plan documents will define a specific testing compensation but others will allow for any 414(s) definition
- If the plan does not utilize a safe harbor 414(s) definition, the alternative definition will have to satisfy compensation-ratio test
- HCE and NHCE must use same definition to determine ADRs and same definition to determine ACRs

Poll Question #3

Aside from using 415 compensation, which of the three safe-harbor exclusions is more frequently used to obtain the best ADP/ACP test results?

A. 415 compensation less pre-tax deferrals
B. 415 compensation with any exclusion that is applied only to some or all HCEs
C. 415 compensation less fringe benefits (cash and noncash), reimbursements or other expense allowances, moving expenses, deferred compensation, and welfare benefits

Example: ADP Test

HCE	Deferral	Gross Comp	ADR	Test Comp	ADR
1	$18,500	$275,000	6.73%	$275,000	6.73%
2	$18,500	$275,000	6.73%	$275,000	6.73%
			6.73% =	ADP =	**6.73%**

NHCE	Deferral	Gross Comp	ADR	Test Comp	ADR
1	$15,000	$150,000	10.00%	$135,000	11.11%
2	$5,000	$85,000	5.88%	$80,000	6.25%
3	$1,000	$40,000	2.50%	$39,000	2.56%
4	$0	$1,000	0.00%	$1,000	0%
			4.60% =	ADP =	**4.98%**

Gross comp for the HCEs is assumed to be well over $275K but limited to $275K (2018 limit). 401(k) are the only pre-tax deferrals.

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Example: ADP Test

HCE	Deferral	Gross Comp	ADR	Test Comp	ADR
1	$18,500	$275,000	6.73%	$275,000	6.73%
2	$18,500	$275,000	6.73%	$275,000	6.73%
			6.73% =	ADP =	**6.73%**

NHCE	Deferral	Gross Comp	ADR	Test Comp	ADR
1-24	$0	$50,000	0.00%	$50,000	0.00%
25	$7,000	$10,000	70.00%	$3,000	233.33%
			2.80% =	ADP =	**9.33%**

Gross comp for the HCEs is assumed to be well over $275K but limited to $275K. 401(k) are the only pre-tax deferrals. There are 25 total NHCE of which only one deferred.

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SEVERANCE COMPENSATION

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Severance Compensation

- Severance? I like to make it really simple, you're fired.

— Donald J. Trump (@realDonaldTrump)

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Severance Compensation

- Severance? Fired? More like, you're terminated.

— Arnold Schwarzenegger (@ArnieGovernator)

Severance Compensation

- Compensation received following severance from employment is generally not considered to be compensation for purposes of 415 compensation with a few exceptions. To be included:
- It must be paid by the later:
  - 2.5 months following severance from employment
  - Or the end of the limitation year in which the severance occurs

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Severance Compensation

- There are two types of compensation to be counted after severance under the final 415 regulations:
  - The final 415 regulations require some post-severance compensation to be included in compensation
  - There is an additional type of optional post-severance compensation allowed under the final 415 regulations

Severance Compensation

- Required: compensation for regular working hours including overtime, commissions, bonuses, or other similar payments; and the payment would have been paid had the employee continued employment

Severance Compensation

- Optional:
- Unused accrued bona fide sick, vacation, or other leave that the employee would have been able to use if employment had continued
- Compensation for a nonqualified unfunded deferred compensation plan and would have been paid at the same time if employment had continued
- Salary continuation payments for military service or disabled participants

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Poll Question #4

Limitation year is January 1 to December 31, 2018. Employee's termination date is May 5, 2018 and "regular" compensation was paid on September 1, 20. Is the compensation paid on September 1, 2018 included in 2018 compensation?

A. Yes

B. No

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Poll Question #5

Limitation year is January 1 to December 1, 2018. Employee’s termination date is December 1, 2017 and “regular” compensation was paid on September 1, 2018. Is the compensation paid on September 1, 2018 included in 2018 compensation?

A. Yes

B. No

DISAGGREGATION

Mandatory Disaggregation

- Mandatory disaggregation - one portion of a plan must be tested separately from another
- 401(k), 401(m), and non-elective components must be tested separately
- Unrelated employers, QSLOBs, and union/non-union must be tested separately
- ESOP and non-ESOP contributions are required to be tested separately; however, they may be combined for ADP/ACP testing

Permissive Disaggregation

- If a plan has more lenient eligibility requirements than the statutory requirements of age 21 and one year of service, then the plan sponsor may elect permissive disaggregation
- Permissive disaggregation separately tests the employees who have attained age 21 and one year of service
  - Non-excludable group have attained age 21 and one year of service
  - Otherwise excludable group have not attained by the end of the plan-year being tested

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Permissive Disaggregation

- Early participation is a variation of permissive disaggregation
  - HCEs who has not met age 21 and one year of service are included in the non-excludable group for ADP/ACP testing. They still must be tested as an otherwise excludable HCE for coverage testing.
- Both variations are commonly used to improve ADP/ACP test results as NHCEs who are under age 21 and have less than a year of service typically have low-contribution percentages

Poll Question #6

Can a plan elect permissive disaggregation for the ADP test but not elect it for the ACP test?

A. Yes

B. No

Poll Question #7

When applying permissive disaggregation, what entry date is used?

A. Statutory
B. Semi-annual
C. Plan’s entry date
D. Immediate

Permissive Disaggregation

- Enough of this permissive disaggregation. I'm going to have a wall built in all testing software applications so there will be no more disaggregation. And, I'm going to get the IRS to pay for it.

— Donald J. Trump (@realDonaldTrump)

Mandatory Aggregation

- Mandatory aggregation of HCEs is required when an HCE is eligible (not just deferring) for more than one 401(k) or 401(m) arrangement
- Mandatory aggregation of HCEs is not applicable if the plans cannot be permissively aggregated (i.e., mandatorily disaggregated groups – union/non-union). However, mandatory aggregation of HCEs still applies if permissive aggregation is not permissible due to different testing methods, different plan year ends, or one plan is safe harbor.

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Mandatory Aggregation

- The total of the HCEs deferral and match contributions are taken into consideration in both plans
- If a plan fails and the refund amount determined for that HCE exceeds their actual contributions to the plan, then the difference is allocated to the HCEs with the next highest dollar amount

Permissive Aggregation

- Two 401(k) or two 401(m) components of the same employer can elect to be permissively aggregated to perform a combined ADP/ACP test
- The components must have the same testing method, the same plan-year end, and if they are aggregated for coverage, they must be aggregated for non-discrimination (ADP/ACP)

The plan sponsor can elect to permissively aggregate some, but not all, components for two related plans (ex. aggregate two non-elective components but still test deferral separate). The 401(k) components would still have to pass coverage separately.

"Shifting"

Shifting

- Shift deferrals to ACP test if two conditions are satisfied:
  - ADP test satisfied with all deferrals
  - ADP test satisfied with non-shifted deferrals

Shifting

- Ex. Shift deferrals to ACP test

	ADP	ACP	
– HCE	5.00%	4.00%	
– NHCE	3.50%	1.75%	
	Pass	**Fail**	Then shift .50% ADP to ACP

– HCE	5.00%	4.00%
– NHCE	3.00%	2.25%
	Pass	**Pass**

All shifting examples use percentages for simplicity, examples in the regulations actually use contributions

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Poll Question #8

Can a plan shift deferrals if the ADP test initially fails?

A. No
B. Yes
C. Ask the IRS agent auditing the plan

Shifting

- The IRS has informally accepted shifting when the ADP test initially fails in the IRS ASPPA Annual Q&A (2009 questions 15 and 16)
- IRS response: “Yes, this is permissible. However, the fact that the correction method for excess contribution refunds allocates the “ROE” to various participants creates mechanical problems that have not been resolved.”
- Consider adding language to the plan document specifically allowing for this

Shifting

- Ex. where ADP initially fails

	ADP	ACP
– HCE	7.00%	2.00%
– NHCE	4.00%	0.75%
	Fail	**Fail**

Plan sponsor corrects by returning one percent of ADP to HCEs

Shifting

- Ex. where ADP initially fails (continued)

	ADP	ACP
– HCE	6.00%	2.00%
– NHCE	4.00%	0.75%

Corrected Fail - Shift 0.75% over for HCE & NHCE

	ADP	ACP
– HCE	5.25%	2.75%
– NHCE	3.25%	1.50%
	Pass	**Pass**

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Poll Question #9

Can a plan shift deferrals for a participant that had deferrals in the ADP test but is ineligible for the ACP test?

A. Yes

B. No

Shifting

- QMAC contributions
- Matching contributions may be included in the ADP test to the extent they are:
  - 100 percent vested
  - Subject to the same distribution restrictions as 401(k) deferrals
  - Designated as QMAC
  - Not tested in the ACP test
  - Not disproportionate (over five percent or two times rep rate)

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Shifting

- Ex. QMAC to be used in ADP test

	ADP	ACP	
– HCE	6.00%	4.00%	
– NHC	3.50%	3.00%	
	Fail	**Pass**	Shift .50% ACP to ADP
– HCE	6.00%	4.00%	
– NHC	4.00%	2.50%	
	Pass	**Pass**	

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Shifting

- Shift QMAC to ADP test and then shift deferrals to ACP test

	ADP	ACP
– HCE	8.09%	2.53%
– NHCE	5.01%	2.00%

Shift 1.08% for NHCE QMAC

	ADP	ACP
– HCE	8.09%	2.53%
– NHCE	6.09%	0.92%

Shift for both HCE & NHCE 4.09% of deferrals

	ADP	ACP
– HCE	4.00%	6.62%
– NHCE	2.00%	5.01%

At 2009 Annual Q&A (Q#30), IRS agreed this approach was permissible

Shifting

- ..

— Hillary Clinton (@whereisHillary?)

Testing Corrections

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Testing Corrections

- Failing ADP tests – options to correct. May use a combination of these methods:
  - Refund deferrals to HCEs
  - QNECs/QMACs
  - Recharacterize deferrals to after-tax

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Refunding Deferrals to HCEs for ADP

Step 1	Step 2
• Calculate the total amount to be refunded • Reduce HCEs in descending order by percentages • Continue to add HCEs in descending order until the adjusted ADP would pass • Determine total refund amount by multiplying the percentage reduced by each HCEs testing compensation	• Allocate refund to the HCEs who deferred the highest dollar amount and continue in descending order • An HCE with the highest dollar may be apportioned a refund despite having a lower deferral percentage

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Testing Corrections

- Refunds distributed after 2.5 months after the plan year are subject to a ten-percent excise tax
- Any associated match must be forfeited
- The same leveling method used to determine excess contributions for the ADP test applies to ACP excess aggregate contributions

Testing Corrections

- QNECs – must be made within 12 months
- Ratio percentage QNECs – uniform percentage of compensation to all eligible NHCEs
- Targeted QNEC – QNEC is greater of five percent of compensation or two times the plan's representative contribution rate – amounts above this are disproportionate and cannot be included

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Testing Corrections

- Although not near as inexpensive as they once used to be (pre-2006), targeted QNECs should be less expensive than ratio percentage QNECs
- Targeted QNECs work best for employers that have participants with low compensation
  - Ex. retail organizations (which have a higher tendency to fail ADP) often have high turnover and have participants with low compensation

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Testing Corrections

- Uniform-dollar QNECs tend to have disproportionate issues. Ex. sponsor wants to give $100 to all NHCE. If an NHCE had only $500 in compensation, generally only $25 can be included in the ADP test.

Testing Corrections

- Recharacterize to after-tax
- If the plan permits, the excess contributions under the ADP test can be recharacterized to after-tax so they are not distributed from the plan
- Must test recharacterized amounts in the ACP test, must be done within 2.5 months after plan-year end, and is still a taxable event to the participant

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Testing Corrections

- ACP regulations state recharacterized contributions are tested in the ACP test in the year they are taxable
- Change in regulations for 2008 plan years ongoing that these contributions would be taxable in the year of distribution
- Q. If a December 31, 2018 plan-year test fails ADP and recharacterizes to after-tax on February 17, 2019. In what year are the amounts tested? 2018 or 2019?

Testing Corrections

- Based on the regulations, they would be tested in 2019. What if the employee terminated in 2018 and has no 2019 compensation?
- Plans can also give the HCEs the choice whether they want to take the distribution or recharacterize.
- Q. Why would any plan sponsor consider this?

Testing Corrections

- This could be a good plan design for plans that are not subject to ACP testing or pass the ACP test with good margins
- Union plans are not subject to ACP test. Some union plans do have HCEs (ex. airline pilots).

Recharacterization

- Recharacterization can provide such great results, it can be used to recharacterize elections and even countries

— Vladimir Putin (@Vladisalwaysright)

Testing Corrections

- Failure to correct a failing ADP/ACP test within 12 months after the plan year could result in a non-qualified CODA
- EPCRS is available. Two pre-approved correction methods provided in EPCRS:
  - Ratio percentage QNEC
  - One-to-one QNEC

One-to-one QNEC is far more popular due to the high cost of correcting via the ratio percentage QNEC

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Mergers and Acquisitions

M&A

- 1.401(k)-5 special rules for mergers, acquisitions, and similar events (reserved)
- IRS asked for comments in Notice 2000-3
- Informal guidance based on GCMs and IRS Q&A
- IRS Q&A 2011 ASPPA Annual Conference Q#29 & Q#34

Have the plan sponsor, preferably with legal counsel, review the purchase and sale agreement to determine what transpired (stock, asset, etc.)

M&A

- Asset transaction
  - An asset purchase is the acquisition of business assets (buildings, equipment, etc.)
  - EEs that go on to work for purchaser are usually treated as having a severance of employment and their account balance in seller's plan is eligible for distribution
  - EE that works for purchaser is treated as a new hire and buyer would not recognize compensation prior to the acquisition

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M&A

- However, treat an asset like stock when the purchaser adopts the plan maintained by the seller or has the employee's account balances directly transferred in a trustee-to-trustee transaction

By directly transferring in the plan balances or adopting the plan, the buyer is continuing sponsorship of the plan and is treated as a continuation of the seller

M&A

- Stock transaction
  - A stock purchase is the acquisition of the stock (ownership interest) of an entity
  - Since the employee continues to work for the same entity, albeit with different ownership, the general rule in a stock sale is that the employee does not have a severance of employment. The employee is treated as a continuing employee. Thus, the employee's compensation prior to the transaction would be recognized for determining HCEs.

M&A

- Stock transaction – exception treat like asset
  - An exception to this rule occurs when a subsidiary is sold to an unrelated parent. Three conditions need to be met for this exception to apply:
    - The subsidiary no longer participates in the original parent company's plan
    - The assets, if any remain, are not directly transferred from plan to plan
    - The subsidiary is no longer considered related to the original parent

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Poll Question #10

What dates of hire should be used for non-discrimination testing for newly acquired employees?

A. Their original date of hire from the acquired employer
B. The date of acquisition
C. The date of hire the plan is using for eligibility purposes
D. Possibly all of the above

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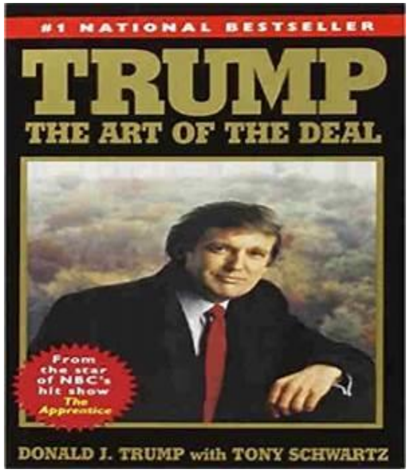
M&A

- Determining HCEs
  - Simplified or top-paid group election is done on an ER basis. If a plan sponsored by an acquired entity had a different HCE determination, one plan will need to be amended.
  - Some practitioners/plan sponsors view the 410(b) transitional rule as providing for separate HCE determinations during the transition period
  - If multiple plans have the top-paid group election, some apply separately to each workforce in the look-back year since they were unrelated until the determination year

M&A



- This M&A talk reminds me of my favorite book, The Art of the Deal. This book is great. It's huge.

— Donald J. Trump (@realDonaldTrump)

M&A

- Testing when plans were merged during the year:
  - Perform one set of ADP/ACP tests by combining/aggregating the plans for the entire year
  - This is generally only available if the plans have the same plan-year end and the same testing method
  - May subject the plans to benefits, rights, and features testing
  - Generally, less complex administratively

M&A

- Testing when plans were merged during the year:
  - Perform two sets of ADP/ACP tests and treat one plan as a terminated plan
  - Often used when the plans have different testing methods (one is SH and the other is not) or the plans have different plan-year ends
  - Terminated plan tests for short period that may require proration of certain limits
  - Surviving plan tests for the entire year and picks up the participants from the terminated plan for the remainder of the year

M&A

- Testing when a plan has related employers in it change to unrelated or vice versa:
  - Treas. Reg. 1.410(b)-7(c)(4)(C)(2) provides that if employees switch from one disaggregation population in the plan to another, benefits accrued in first group may be treated as provided to them in their current group (test for whole year based on last group they were in)
  - Only if it is applied on a consistent basis and does not result in significant discrimination in favor of HCEs
  - May eliminate the need to break out and perform tests while related and then separate tests for the other portion of the year when they were unrelated (which adds a considerable amount of data and complexity)

Questions?

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