Non-Discrimination Testing & Corrective Distributions

The IRS requires that retirement plans perform annual non-discrimination tests to ensure that the benefits from a company's 401(k) plan are widely shared. This is done to make sure that the retirement plan doesn't disproportionately favor employees classified as "highly compensated employees" (HCE).

An employee is considered a highly compensated employee if they fall into one of two categories:

1. Individual owns more than 5% of the Employer. Attribution rules apply where ownership of certain family members is considered to be owned by the individual.
2. Employee received compensation above the IRS defined limit for the previous year ($125,000 for 2019).

All other employees are considered "non-highly compensated employees" (NHCE) for purposes of the non-discrimination testing.

WHAT IS THE NON-DISCRIMINATION TEST?

There are two non-discrimination tests performed each year.

1. **Actual Deferral Percentage (ADP) Test:** The ADP test compares the average deferral rates of HCEs to NHCEs. Deferral rates are calculated by dividing the employee's total deferral for the year by their total compensation (as defined in the plan document). To pass the test, the average deferral rate for HCEs may only exceed the NHCEs by specific limits summarized below:

NHCE Percentage	Maximum HCE Percentage
2% or less	NHCE% x 2
2% - 8%	NHCE% + 2
More than 8%	NHCE% x 1.25

2. **Actual Contribution Percentage (ACP) Test:** The ACP test compares the average contribution percentage of HCEs to NHCEs. The calculation is done by dividing the employee's total employer match(plus any after-tax contributions the employee made) by their total compensation (as defined in the plan document). To pass the ACP test, the HCE group contribution percentage may only exceed the NHCE group percentage by the same limits as in the ADP test described above.

WHEN ARE CORRECTIVE DISTRIBUTIONS REQUIRED?

If the retirement plan doesn't pass either of these tests then corrective distributions must be made to HCEs until the group's actual deferral or actual contribution percentage falls within the allowed threshold.

WHEN IS NON-DISCRIMINATION TESTING PERFORMED?

The non-discrimination testing is performed after the end of the Plan Year. Full year employee data including compensation, deferrals and match are required in order to accurately complete the test. Should the plan not pass the test and corrective distributions are required, they must be completed within 2 ½ months after the plan year end. If corrective distributions are paid

after 2 ½ months there is a 10% employer paid penalty. *Please note if your plan implements an Eligible Automatic Contribution Arrangement the refund deadline will be extended from 2 ½ to six months. Please refer to your plan's Summary Plan Description to see if this provision and extension applies.*

HOW CAN MY PLAN AVOID FAILING THE NON-DISCRIMINATION TESTING?

1. Improve employee participation: Since the tests look at deferral/contribution rates of all employees, a low participation rate from NHCEs bring down the groups average significantly. Ways to increase participation may include:

- More retirement planning education
- Adding an automatic enrollment provision
- Introducing/increasing your employer match contribution

2. Add a Safe Harbor Plan Design : A Safe Harbor design automatically exempts a plan from non-discrimination testing. In order to be considered a Safe Harbor Plan, there is a requirement to make an employer contribution to eligible employees. If you are interested in learning more, contact your Sentinel Plan Consultant.