

GET (K)ONNECTED 401(K) PLAN NEWSLETTER

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IS YOUR 401(K) FAILING? HOW TO GET A PASSING GRADE

If you sponsor your own 401(k) plan, you know that each year your plan must pass a series of nondiscrimination tests. If your plan regularly fails these tests, you may benefit from 401(k) 101.

401(k) plans must pass the Average Deferral Percentage Test. This test compares the average deferral rate of your Non-Highly Compensated Employees (NHCEs) with the average deferral rate of your Highly Compensated Employees (HCEs).

If your HCEs' average deferral rate is "too high" relative to the average deferral rate of your NHCEs, your plan will fail the ADP test and typically some portion of your HCEs' contributions will be returned to them. The HCEs' deferral rate is considered "too high" if it is more than the lesser of two times or two plus the NHCEs' deferral rate. For example, if the average deferral rate for the NHCEs is 3.0%, then the HCEs' deferral rate can be no more

than 5.0% to pass the test (NHCE rate plus 2). If the average deferral rate for the NHCEs is 1.0%, the HCEs' deferral rate can't be above 2.0% (NHCE rate times 2).

Who fails and why do they fail? It's all about the numbers. Most companies fail because their NHCEs are not contributing enough to the plan. All eligible

employees are part of the test, so non-contributing employees can significantly reduce the overall NHCE deferral average. For example, if a company has 10 NHCEs and 5 of them contribute 6% to the plan and the other 5 contribute 0% to the plan, the company's overall NHCE deferral rate is only 3% -- limiting the HCEs to an average contribution of only 5%.

Company owners and employees that earn over \$150k are "HCEs". Their ability to contribute to your 401(k) may be limited.

Some companies fail, however, because of the deferral rates of the HCEs. Particularly in smaller companies, a single outlier can significantly affect the numbers. For instance, the owner's spouse may be on the company's payroll in a limited capacity. If he/she earns \$20,000 and defers \$5,000, his/ her deferral rate of 25% will significantly skew the ADP test even though the total amount deferred is relatively minor.

Knowing how the tests work can help you help yourself. Also be aware that with the right plan design you can improve your chances of passing the tests, and in some cases, ensure you pass the tests regardless of the deferral rate of your NHCEs. From automatic enrollment to safe harbor designs, a different plan design may help you to make your plan a real benefit to all of your employees.

FREE PLAN DESIGN CONSULTATION

Does your plan need a plan design overhaul? Our plan design experts can help! Your company's retirement plan is not just another benefit. When properly designed, it can be an integral part of a strategic compensation package that not only helps your employees prepare for retirement but also helps you retain great talent while minimizing your payroll costs. But for many companies, their retirement plan falls far short of these goals. Those who are able to participate often do not, while those that want to participate often cannot. Learn what your retirement plan can do for you and your employees today!

As an adopting employer or our pooled employer plan, you will receive complementary plan design services from our experienced retirement plan specialists.

If you would like more information about joining a pooled employer plan, contact us today! We will arrange a plan consultation with a retirement specialist to help you determine if joining a pooled employer plan is the right move for your company.

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