Chapter 9
Compliance Testing

Plan sponsors are responsible for ensuring that their qualified retirement plans comply with the laws and regulations governing them. Therefore, it is imperative that you monitor your plan's operations in the following areas that greatly affect the compliance status of your plan:

- Timely completion and submission of all documentation required for DOL and IRS governmental reporting, including IRS Form 5500 and annual compliance testing
- Compliance with ERISA, new or existing tax legislation, regulations or IRS and DOL guidance that may affect your plan
- Calculation of vesting percents for employer matching and/or profit-sharing contributions, if your plan contains a graded vesting schedule
- Administration of participant hardship withdrawals and loans, including calculating amounts available for loans and hardship withdrawals, supplying all required participant information and documents and tax reporting of hardship withdrawals and defaulted loans

In addition, TRS requests you to provide census data to assist in identifying several classifications of employees, including highly compensated employees (HCEs), officers and key employees. This information is used to perform the annual compliance tests described later in this section. Timely and accurate data must be provided to avoid possible disqualification of your plan or monetary penalties.

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Minimum Coverage Tests

Internal Revenue Code (IRC) Section 410(b) sets standards for the percentage or number of employees a plan must cover. A plan must pass one of the following tests:

- Ratio Percentage Test: The percentage of nonhighly compensated employees (NHCEs) benefiting from the plan must be at least 70% of the percentage of highly compensated employees (HCEs) benefiting from the plan.
- Average Benefits Test: The average benefit of the NHCEs must be at least 70% of the average benefit of the HCEs.

A highly compensated employee, or HCE, is defined in the IRC as an employee in any of the following categories:

- An individual who owns more than 5% of the interest in the business at any time during the current or preceding year, or a lineal ascendant or descendant of that person, such as a parent, spouse, child, or grandparent—with some restrictions
- An employee who for the previous year received compensation from the employer of more than $100,000 (in 2007, and indexed annually for inflation)
- An employee whose current-year compensation is at least $105,000 (for 2008, and indexed annually for inflation)
- Finally, if the employer chooses, those in the top 20% of all employees when ranked by compensation

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In applying the coverage rules, a plan may exclude certain employees who, for testing purposes, are referred to as "excludable employees." Excludable employees are:

- Employees failing to satisfy the plan's minimum service and age requirements—in other words, employees ineligible to participate in the plan
- Union employees for whom retirement benefits are the result of collective bargaining agreements
- Nonresident aliens who receive no U.S. income
- Employees of separate lines of business (SLOB) of the employer. A separate line of business is a "line of business that is organized and operated separately from the remainder of the employer." SLOB rules state various objective factors that can be used to determine whether lines of business are separate, and so allowed to be treated as qualified separate lines of business (QSLOB) for testing purposes
- Certain terminated employees who worked less than 500 hours during the plan year

A separate line of business is a "line of business that is organized and operated separately from the remainder of the employer."

Compensation Ratio Test

Because IRC Section 401(a)(4) measures discrimination by looking at each participant's plan contributions in relation to his or her total compensation, the definition of compensation is very important. IRC Section 414(s) provides a number of options for defining compensation.

However, any alternate definition—for example, one that excludes bonuses or overtime—requires that a test be performed to compare the average compensation ratio of the NHCE group to the average compensation ratio of the HCE group. The difference between the average group ratios for HCEs and NHCEs cannot not be more than a *de minimis* percentage. The IRS does not define *de minimis*, but TRS considers a difference between the HCE and NHCE ratios of 3% or more no longer *de minimis* and thus discriminatory.

If the plan's definition of compensation does not satisfy the ratio test's requirements, the plan may need to be amended to include some or all of the pay components it excludes from compensation until it can pass this test.

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Actual Deferral Percentage (ADP/401(k)) and Actual Contribution Percentage (ACP/401(m)) Tests

IRC Section 401(a)(4) mandates that qualified plans cannot discriminate in favor of HCEs. The 401(k) and 401(m) tests, also known as the ADP and ACP tests, respectively, are generally the prescribed way for 401(k) plans to satisfy the discrimination requirements related to employee deferrals and employer matching/employee after-tax contributions. If your plan does not pass the ADP and ACP tests, corrective distributions, in the form of refunds to HCEs, or an additional employer contribution called a Qualified Non-Elective Contribution (QNEC) or Qualified Matching Contribution (QMAC) to some or all NHCEs must be made in order for your plan to pass these tests.

Qualified plans must not discriminate in favor of HCEs.

Cross-Testing for New Comparability Plans

So-called "New Comparability" plans may satisfy the IRC Section 401(a)(4) benefits discrimination requirements through the use of a technique called "cross-testing." Under the cross-testing method, contributions are converted to equivalent benefits payable at normal retirement age, and these benefits are then used for testing purposes. These plans typically group employees into classes for the purpose of allocating employer contributions, and each class receives a different percentage-of-pay allocation.

Top-Heavy Test

IRC Section 416 defines a "top-heavy" plan as one in which more than 60% of the total plan assets reside in key employee accounts.

Generally, account balances as of the last day of the preceding plan year are used to determine the top-heavy status for the following plan year. However, for a new plan, account balances as of the last day of the *first* plan year are used to determine the plan's top-heavy status for *both* the first and second plan years.

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A key employee is any employee or former employee, including a deceased employee, who is in one of the following categories:

- An employee who owned more than 5% of the business during the plan year
- An employee who owned more than 1% of the business and had annual compensation greater than $150,000
- A corporate officer who received compensation in excess of $145,000 in 2007; $150,000 in 2008; adjusted annually for inflation
- A spouse or lineal family member of an owner described in the first two categories listed above. A lineal family member is defined as a spouse, parent, child or grandparent of the owner

If the plan is top-heavy, the law requires that the sponsoring employer make minimum contributions to all eligible nonkey employees, and utilize one of the top-heavy vesting schedules defined in the regulations as well. Based on your plan's design, these top-heavy requirements may affect your plan's operation, and may also require an amendment to your plan document.

Section 415 Annual Addition Test

IRC Section 415 dictates that the maximum annual addition that can be made on behalf of a participant in a defined contribution plan for a limitation year is the lesser of:

- $46,000 in 2008, indexed annually for inflation, or
- 100% of a participant's compensation in the limitation year

An annual addition is comprised of elective deferrals, after-tax contributions, employer contributions and forfeitures. If your company maintains, or has maintained, more than one plan, there are special rules for determining the overall limitations.

The limitation year is the plan year, unless another consecutive 12-month period is elected. Refer to your plan document for the definition of your plan's limitation year.