Manulife Retirement | John Hancock

2026 Plan sponsor guide to *compliance* testing

Provided by the Manulife John Hancock retirement plan services defined contribution benefits consulting group

Contents

Introduction

Our compliance testing guide provides an overview of the annual compliance tests usually performed after the end of the plan year, and the potential correction methods should your plan fail any tests. It's designed to help you quickly access the compliance testing information you need and serve as your resource as you review your results.

Please contact your Manulife John Hancock representative if you have any questions about your results or the testing methods used. If your plan fails any of the required tests, you have a limited amount of time to correct the test and maintain the plan's qualified status.

The results of your compliance tests can help you review your plan design. Consistently failing one or more tests could mean your plan doesn't match your employee demographics and may not include design capabilities created by recent legislative changes. In some cases, enhancing your employee communications may increase participation enough to significantly affect testing results. If you'd like to discuss potential changes to your plan design or employee communications, please feel free to contact your Manulife John Hancock representative to request assistance from the benefits consulting group.

Important reminders

Use of forfeiture accounts

Please review your plan document to determine how the plan's forfeiture account balances (if any) should be used. For most plans, forfeiture balances need to either be allocated as additional employer contributions, used to reduce employer contributions, or used to pay routine plan administration expenses. Forfeiture accounts generally have to be allocated annually, and they can't be distributed without written authorization from the plan.

Contribution deduction deadline

Employer contributions must be allocated by the due date of the employer's federal tax return (including extensions) to be deductible by the employer.

Data requirements

We'll perform a preliminary determination of Highly Compensated Employees (HCEs) based on the data collected during the previous plan year. In addition, we'll send you a Compliance Workbook each year to collect additional information. It's your responsibility to provide us with updates to Ownership and Officer Information, and any updates to compensation or employee data. The information you provide in the Compliance Workbook is required to complete your plan's annual testing and prepare the Form 5500 Annual Report. Failure to provide accurate information could result in delayed or inaccurate results. Below are examples of the data requested that you should review for accuracy.

Compensation

Please review your plan document for the definition of compensation used by your plan for testing purposes. This may or may not be the same definition used by your plan for other purposes, such as Section 415 testing or determining contribution amounts.

For example, some plans may exclude compensation paid before an employee became eligible to participate in the plan. If your plan contains this provision, testing compensation paid for the period before the employees become eligible could be excluded from the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) Tests, but must still be included in Section 415 testing. Compensation earned during any period in which an employee was eligible must be included, even if they don't make salary deferrals to the plan.

Eligible employees

Please ensure that all employees who received compensation at any time during the plan year, including those who terminated during the year and those who elected not to participate, are listed on the Employee Census prior to authorizing testing.

Identification of certain employees

Nondiscrimination tests are a comparison between groups of employees, and accurate results depend largely on classifying employees correctly. Understanding the criteria used to differentiate between participant classifications can be useful in reviewing your results. The HCE and Key Employee determinations for each employee are listed in the HCE/Key Status Report included with your testing results.

Highly Compensated Employees (HCEs)

The ADP and ACP tests compare deferral and matching contribution percentages of HCEs to those of Non-Highly Compensated Employees (NHCEs). As such, the correct identification of HCEs is critical to an accurate test. We can assist you in identifying HCEs; however, you, as the employer and plan administrator, are responsible for making certain that all employees who should be included in this group are identified.

An employee is an HCE for the current plan year if they satisfy any of the conditions below:

- Earned in excess of the compensation limit during the **prior** plan year, known as the look-back year (or prior 12-month period, if the prior plan year was less than 12 months, regardless of the amount of compensation paid during the plan year being tested (the determination year).
- Owns **more than 5%** (either directly or by family attribution) of the business at any time during the plan year being tested or the look-back year.

Note: Certain family members of 5% owners are treated as having the same share of ownership under IRC Section 318, including the owner's spouse, parents, grandparents, and children. For example, if a husband and wife work for the same employer and the husband owns 50% of the business, due to family attribution rules, his wife also owns 50% of the business and is an HCE/Owner regardless of her compensation.

HCEs top-paid group election

Your plan document can apply an alternative definition of HCE for determining which employees are HCEs. The top-paid group election allows you to limit the HCE group to owners and the top 20% of employees (including employees of other companies in a Controlled Group or Affiliated Service Group) when ranked by compensation. When the top-paid group election is made, employees who aren't in the top-paid group for the look-back year are treated as NHCEs, even if their compensation exceeds the compensation limit. To determine if your plan uses the top-paid group election, see the HCE definition in your Adoption Agreement.

To determine the number of employees in the top-paid group, include all employees who were employed at any time during the look-back period, including employees who weren't eligible to participate. Then, exclude the following employees:

- Those with less than six months of service
- Part-time employees (scheduled to work less than 17½ hours per week)
- Seasonal employees who normally work less than six months during the year
- Employees under age 21 as of the end of the look-back period
- Nonresident aliens with no U.S. source income
- Employees in a collective bargaining unit (if 90% or more of all employees are union members and union members are excluded from the plan)

After excluding the employees above, multiply the total number employed by 20% to determine the *size* of the top-paid group (rounding up or down to a whole number).

All employees, regardless of whether they're eligible, are ranked in descending order of compensation for the look-back year.

Starting with the highest-paid employee, count down the total number in the top-paid group to determine *which* employees are included. Employees who aren't eligible are included in this count and are still HCEs in the top-paid group, if they also satisfy the compensation test.

Example: top-paid group election

A plan using the top-paid group election for the 2026 plan year had the following employees who exceeded the compensation parameter ($160,000) for the look-back year (2025 calendar year).

Employee	Salary
1	$225,000
2	$190,000
3	$183,000
4	$175,000
5	$170,000
6	$163,000

If there were 15 employees in the look-back year, the total number of HCEs in the top-paid group is limited to 3 (i.e., 15 x 20%). Therefore, employees 4, 5, and 6 are treated as NHCEs because they're not in the top-paid group and aren't 5% owners.

If the plan didn't use the top-paid group election, all 6 employees would be treated as HCEs, because their compensation exceeds the parameter for the look-back year.

Key Employee

A Key Employee is any employee who, at any time during the plan year:

1. Owned more than 5% of the employer, or related employer (attribution rules apply, see the note in HCE definition); or
2. Owned more than 1% of the employer (attribution rules apply) with compensation greater than $150,000; or
3. Was an officer with compensation greater than the compensation limit ($235,000 in 2026)

Attribution rules

When determining ownership for the purpose of identifying HCEs and Key Employees, an individual is considered to own the stock of their spouse (other than a spouse who's legally separated), child, grandchild, or parent. A legally adopted child is treated as a child of the individual.

Ownership can be attributed to an organization, including a partnership, estate, trust, or corporation. An individual is

considered to own stock that's owned by a partnership. If a corporation has an ownership interest in another organization, that interest is attributed to any person who owns at least 5% of the value of the stock of the corporation.

You must thoroughly review your employees' ownership percentages and trace ownership through trusts, estates, and other entities to correctly identify HCEs and Key Employees.

The ownership rules for determining common ownership to create a Controlled Group of Businesses or an Affiliated Service Group differ from those used to determine ownership for identifying HCEs and Key Employees.

Officer

An officer for the purpose of determining Key Employees means a key administrative executive of the company, not necessarily anyone with a corporate title. The term officer refers to the level of authority an employee has. For top heavy purposes, IRS guidelines allow you to limit the number of employees considered officers to 10% (but not fewer than 3 or more than 50). Only officers with compensation over the annual compensation limit (see Benefit and contribution limits) are treated as Key Employees.

Ownership interest—HCE/Key Employee determination

Determining employee ownership depends on the type of organization. Ownership in a corporation is based on the greater of (a) the percentage of the total value of all classes of stock, or (b) the percentage of total voting power for all classes of stock with voting rights. For a partnership, ownership is the greater of the percentage of capital interests or profit interests. Ownership for an LLC or LLP is generally referred to as membership interest.

Benefit and contribution limits

Four-year cost-of-living adjustments summary

Plan limits	2026	2025	2024	2023
Maximum deferral (Section 402(g))	$24,500	$23,500	$23,000	$22,500
Catch-up for 401(k) plans	$8,000	$7,500	$7,500	$7,500
Super catch-up for 401(k) plans—participants ages 60 to 63	$12,000	$11,250	NA	NA
Defined contribution annual contributions (Section 415)	$72,000	$70,000	$69,000	$66,000
Maximum compensation	$360,000	$350,000	$345,000	$330,000
HCE compensation limit (applicable for prior year)	$160,000	$155,000	$150,000	$145,000
Key Employees officer compensation	$235,000	$230,000	$220,000	$215,000
1% owner compensation	$150,000	$150,000	$150,000	$150,000
Taxable wage base	$184,500	$176,100	$168,600	$160,200

Annual compliance testing

Elective deferral limit—IRC Section 402(g) test

IRC Section 402(g) limits the amount of elective deferrals that an individual may exclude from their gross income in a single calendar year and is indexed by Congress. The IRC Section 402(g) dollar limit affects the individual's federal income tax consequences (see Benefit and contribution limits). When a participant defers more than the maximum, an excess deferral occurs and could lead to plan disqualification if not corrected.

Catch-up contributions and the salary deferral limit

Individuals who are age 50 or older by the end of the calendar year are allowed to make an additional contribution above the limits if your plan provides for such contributions. Catch-up contributions don't count against the individual's 402(g) or 415(c) annual additions limit, and don't count in the determination of the deferral limits defined in the plan document. Catch-up contributions are also not considered in the ADP test and may provide a means for HCEs to avoid receiving a corrective distribution to correct a failed ADP test. See the Benefit and contribution limits for catch-up contributions.

Plan limits on elective deferrals

There are three limits that might affect the amount of an employee's elective deferrals for a year:

1 Plan-imposed limits

Plan limits refer to limits on the amount of elective deferrals that can generally be made during the plan year. They're specified by you in the plan document rather than in the Internal Revenue Code. You can use elective deferral plan limits to manage HCE averages for your ADP test or to initiate the point of catch-up contributions. For example, your plan document could limit the HCE elective deferral rate to 10% of compensation or limit all participants to 15% of compensation for the plan year.

- **Split compensation periods—**In some cases, a plan limit may apply at a certain rate for part of the year, and a different rate for another part. This could happen if the plan limit was changed during the plan year through a plan amendment. The plan limit is applied to the compensation earned during each part of the year.

  Example: Participant A earned $50,000 in the first half of the plan year, and the plan limit on deferrals was 10%. During this period, they contributed $6,000, which was $1,000 more than the plan limit in effect. In the second half of the year, Participant A earned another $50,000, and the plan limit was 8%. During this period, they contributed $3,000, which was $1,000 less than the plan limit in effect. As a result of the split compensation period, Participant A would have an excess plan limit salary deferral of $1,000.

- **Alternative method—**For purposes of determining catch-up contributions, a plan may apply plan limits as a time-weighted average of the separate deferral limits over the course of a plan year. In the above example, the time-weighted average of the deferral limits is 9% (10% + 8% divided by 2). This time-weighted average is applied to Participant A's total plan-year compensation of $100,000 to determine their plan-year deferral limit, which is $9,000. Since Participant A contributed $9,000 during the plan year, there weren't any excess deferrals for purposes of determining catch-up contributions using this calculation method.

  Testing for plan limits is performed on a time-weighted average basis unless the plan sponsor provides separate compensation for each portion of the year and specifically requests the split compensation period method.

- **Catch-up contributions—**Salary deferrals made in excess of the plan limits may qualify as catch-up contributions if the participant is eligible to make catch-up contributions and hasn't reached the catch-up contribution limit by the end of the plan year. For example, if the plan limits HCE contributions to 10% of plan year compensation, and a catch-up eligible participant earning $200,000 makes a contribution of $20,500 ($500 more than the plan limit), the $500 is treated as a catch-up contribution. In addition, the plan limit is determined after subtracting out any catch-up contributions that were recognized during the plan year as a result of performing the elective deferral limit—IRC Section 402(g) test.

2 ADP test limit

The ADP test is used to determine if your plan satisfies the nondiscrimination requirements of IRC Section 401(a)(4). One component of the ADP test is to determine the maximum average deferral rate for HCEs who are eligible during the plan year, known as the ADP test limit. The ADP test may restrict the total amount of elective deferrals made by an HCE, even though the amount deferred was within the IRC Section 402(g) dollar limit. The ADP test is discussed in more detail in the Actual Deferral Percentage Test and Actual Contribution Percentage Test section of this guide.

3 IRC Section 415 limit

Elective deferrals are part of the annual additions limited by IRC Section 415. This limit applies to all annual additions, including employer contributions, after-tax employee contributions, and forfeiture allocations, not just elective deferrals. IRC Section 415 is described in more detail in the next section.

Annual additions limit—IRC Section 415(c)

A defined contribution plan must limit the annual additions that are allocated to a participant's account for a limitation year. All qualified retirement plans are subject to the annual additions limit test.

Plans included/excluded

- If employees participate in more than one defined contribution plan sponsored by the same or related employers, contributions to *all* such plans must be taken into account in applying the annual additions limit test.
- Employees who participate in a defined contribution and a defined benefit plan maintained by the same or related employers may disregard contributions made to each plan when applying the Section 415 limit. However, after-tax contributions made to a defined benefit plan must be applied across all plans.
- Employees who participate in a defined contribution plan and a 403(b) plan maintained by the same or related employers may disregard contributions made to each plan when applying the Section 415 limit.
- The total annual additions to each participant's account for any limitation year can't exceed the lesser of 100% of Section 415 compensation or the applicable dollar limit ($72,000 for 2026), not including catch-up contributions. See Benefit and contribution limits.

Limitation year

For defined contribution plans, the limitation year is used for measuring annual additions. It's generally the calendar year, unless otherwise stated in your plan document. Determining the limitation year for non-calendar year plans and short limitation years is discussed later in this section.

Annual additions

Contributions that are considered in annual additions include:

- Employer contributions, including elective deferrals under a 401(k) plan, matching contributions, and nonelective contributions
- Forfeitures allocated to the participants' accounts
- Employee contributions (i.e., after-tax contributions)

Certain additions disregarded

Some additions to a participant's account are disregarded, including:

- Rollovers and transfers
- Loan repayments
- Catch-up contributions
- Investment earnings
- Cash-out repayments and restorative allocations

Treatment of excess amounts

Elective deferrals made by HCEs that are refunded to correct a failed ADP test are treated as annual additions for the limitation year in which they were allocated unless they're recharacterized as catch-up contributions. Similarly, employer matching contributions and after-tax contributions are still annual additions for the year allocated, even if they're distributed to HCEs to correct ACP test violations. Elective deferrals that exceed the IRC Section 402(g) limit but are distributed by the April 15 deadline aren't treated as annual additions.

Contribution timing

As a general rule, employer contributions are credited as annual additions in the limitation year if, under the terms of the plan, the contributions are allocated to the participant's account as of a date in that limitation year. If the employer contributions are made after the end of the year, the contributions aren't treated as credited to a participant's account for the limitation year unless the contribution is actually made no later than 30 days after the period during which the contributions were deductible—the due date (including extensions) for filing the employer's federal income tax return for the tax year in which the limitation year ends.

Timing of corrective contributions

Plans may make qualified nonelective contributions (QNECs) to correct ADP test violations (see Correction methods—ADP/ACP test). Although QNECs can be allocated up to 12 months after the end of the plan year, they're only treated as annual additions for that prior year if they're contributed no later than 30 days after the due date for filing the employer's tax return. If the contributions are made after that date, they're treated as annual additions for the current year, even though they're allocated for the prior year.

Non-calendar year plans

For non-calendar year plans, the limit is the calendar year limit in which the plan year ends. For example, a plan with a June 30, 2026, year-end will use the 2026 calendar year limit ($72,000).

Short limitation year

Short limitation years may occur in a number of situations, including when a new plan is established, a plan is amended, or a merger takes place. The annual additions limit must be prorated for short plan years.

Example: The 2026 annual additions limit for an individual employee is $72,000. This limit must be prorated for a short plan year. Assume a new calendar-year plan is created with an effective date of May 1. The period from May 1 to December 31 is a short plan year. The annual additions limit for the short plan year beginning May 1, 2026, to December 31, 2026, is $48,000 (8/12 x $72,000; total number of months in the short plan year being tested).

Correcting excess annual additions

If a participant's annual additions exceed the maximum limit, a correction should be made in accordance with your plan document. Corrections to excess annual additions should be made as soon as possible after the excess is identified, but no later than 12 months after the plan year being tested. See Correction methods—Excess annual additions for details.

Actual Deferral Percentage Test and Actual Contribution Percentage Test

Qualified retirement plans are subject to ADP and ACP nondiscrimination testing under IRC Section 401(a)(4). Nondiscrimination tests compare the contribution rates of HCEs to those of NHCEs to make sure your plan isn't favoring the HCEs.

The ADP test is used to determine if your 401(k) arrangement, pretax and Roth salary deferrals, satisfies the nondiscrimination requirements of IRC Section 401(a)(4). The ACP test applies to your 401(m) arrangement (employer matching and employee after-tax contributions). The ADP and ACP tests limit the average contribution percentages of HCEs in relation to the average contribution percentages of NHCEs. Except for plans that satisfy specific ADP/ACP safe harbor or automatic enrollment safe harbor requirements (see Traditional safe harbor arrangements), ADP/ACP testing is required for all 401(k) plans and for other defined contribution plans that allow employee or employer matching contributions. In certain circumstances, ADP safe harbor plans may be subject to ACP testing.

Calculating ADP and ACP percentages

- The total pretax and Roth deferrals for each employee are divided by the employee's compensation to determine their Actual Deferral Ratio (ADR).
- The total after-tax and matching contributions for each employee are divided by the employee's compensation to determine their Actual Contribution Ratio (ACR).
- The individual percentages are averaged to determine the ADP/ACP for the respective group.
- The HCE and NHCE group ADP/ACP are then applied to the regulatory parameters discussed below.

Example: Calculation for an NHCE group

ADP for NHCE group

NHCE	Compensation	Salary deferral	ADR (%)
1	$70,000	$4,000	5.71%
2	$28,000	$0	0.00%
3	$30,000	$800	2.67%
4	$10,000	$0	0.00%
5	$47,000	$2,000	4.26%
ADP calculation	5.71% + 0 + 2.67% + 0 + 4.26% = 12.6% 12.6/5 = 2.53% NHCE ADP		

NOTE: In this example, employees who are eligible but didn't defer are included in the calculation.

ADP/ACP test limit

The HCE group averages for the ADP and ACP tests are compared to the NHCE percentages. The NHCE averages may be based on the current plan year for the prior plan year, depending on the testing method elected in your document.

The HCE group averages can't exceed one of the following limits:

- **Basic limit:** 1.25 times the ADP/ACP of the NHCE group
- **Alternative limit:** The lesser of:
  - The NHCE average ADP/ACP times 2 or
  - The NHCE average ADP/ACP plus 2 percentage points

In the example above, where the ADP for NHCEs is 2.53%, the HCEs ADP can't exceed 4.53% (2.53% plus 2%).

Failed ADP/ACP Tests

If the average ADP or ACP for the HCE group exceeds both the basic and alternative limits, your plan fails the test, and corrections must be made according to the provisions of your plan document. Permitted correction methods are outlined in the Correction methods—ADP/ACP test section of this guide.

Borrowing method

In certain circumstances, you can shift employee deferrals or employer contributions from the ADP test to the ACP test or vice-versa to improve the results. For example, if the ADP test passes but the ACP test fails, including pretax deferrals in the ACP test instead of the ADP test may allow your plan to pass the ACP test. Employer matching contributions may only be included in the ADP test if they qualify as qualified matching contributions (QMACs).

Prior-year testing method

Plans that use the prior-year testing method compare the HCE group averages for the current year against the NHCE averages for the previous plan year. The prior-year method uses the NHCE group averages to determine the maximum ADP average for the HCE group, making it easier for a plan to pass the ADP/ACP test. Prior-year testing helps you understand the passing parameters before the plan year begins, allowing you to cap HCE deferral rates to prevent failure. If you use this method, you can't make corrective contributions (QNECs or QMACs) to correct a failed test.

Current-year testing method

Plans that use the current-year testing method compare the HCE group averages for the current year against the NHCE averages for the same year. If you use this method, you won't be able to limit the averages for the HCE group. However, you can make corrective contributions to correct a failed ADP/ACP test.

Changing the testing method

A plan may execute an amendment to change the current- or prior-year testing method, with some limitations. For calendar year plans, the amendment must be executed by December 31 of the plan year being tested to be effective for the current calendar year ADP/ACP test.

A plan may switch from prior-year testing to current-year testing in any year. However, you must perform the ADP/ACP test using the current-year testing method for at least five years. Switching from current-year to prior-year testing can only be done if the plan has used the current-year method for the last five plan years.

Catch-up contributions

Catch-up contributions aren't included in the ADP test. If a participant (who's eligible to make catch-up contributions because they're at least 50 years old) contributed $26,000 of elective deferrals in 2026, and $1,500 of those contributions are catch-up contributions, only $24,500 of the deferrals will be considered when performing the ADP test. See Catch-up contributions overview.

Otherwise excludable employees

Plans that allow for eligibility less than the maximum age and service requirement of age 21 and 1 year of service may apply the option of creating separate coverage groups for testing in a plan year, placing those not meeting the maximum age and service requirement separate from the group that meets the maximum age and service requirements. This is called permissive disaggregation of otherwise excludable employees.

If you disaggregate otherwise excludable employees to satisfy the Minimum Coverage Test, you must also perform nondiscrimination testing separately for them. Conversely, if you don't elect to disaggregate otherwise excludable employees for minimum coverage testing, you can't disaggregate them for your ADP and ACP tests for that plan year.

Minimum Coverage—IRC Section 410(b) test

IRC Section 410(b) requires a qualified retirement plan to cover a nondiscriminatory ratio of employees, known as the Minimum Coverage Tests. There are two coverage tests: ratio percentage and average benefit, and your plan must satisfy one of them. The coverage test ensures that employees are eligible to participate in your plan on a nondiscriminatory basis while considering your entire workforce. The test must be performed separately for each of the following contributions:

- Employee salary deferrals (including Roth)
- Employer matching contributions and employee after-tax contributions
- Employer nonelective contributions or any other employer contributions

The test requires census information for all related or affiliated employers in order to determine if the benefit ratios unfairly discriminate in favor of your HCEs. Under a 401(k) arrangement and matching component, an employee may be treated as benefiting if they're eligible to contribute to the plan. An employee benefits under a nonelective arrangement if they receive an allocation of employer contributions or forfeitures for the plan year.

Generally, most plans will use the ratio percentage test to satisfy minimum coverage requirements. The ratio percentage test is satisfied if your plan's coverage of NHCEs isn't significantly less than its coverage of HCEs. Specifically, the ratio percentage coverage test passes if the number of NHCEs that benefit under the plan is at least 70% of the number of HCEs benefiting under the plan.

In some cases, multiple plans of the employer may be combined and tested on an aggregated basis. It's important that you inform us if you have more than one plan or if employees within a Controlled Group of Businesses aren't covered by the plan. Information about all employees must be included in the test, even though the test is conducted for each plan separately, and even if the plan only covers one group of employees. If your company is part of a Controlled or Affiliated Service Group, information about all employees of all members in the group must be provided.

Finally, depending on your situation regarding your employee workforce and retirement plan coverage, other minimum coverage testing options may exist. Please contact us to determine if further testing might be beneficial.

Related-employer employees of a Controlled Group of Businesses/Affiliated Service Group not covered under the plan we service

Under the terms of our Administrative Services Agreement, we provide services applicable to the plans of the employer under the service agreement contract. For minimum coverage testing, related employer workforces not covered by our client's plan will be factored as non-benefiting employees in the benefiting ratio percentage tests. We may, as a special service, perform minimum coverage testing, factoring benefiting ratios of plans not covered under our service agreement, provided that the census information for all employees in the Controlled or Affiliated Service Group is given to us. We can't factor this into a Minimum Coverage Test without full census information for all employers and plans.

If you have more than one plan and there are ratio percentage testing failures, you may wish to perform the Minimum Coverage Test on an aggregate (combined) basis instead. Please notify us as soon as possible if you wish to perform coverage testing on an aggregate basis, as this may affect other testing results, including your ADP and ACP tests.

Controlled Group of Businesses/related employers are defined in IRC Sections 414(b), (c), and (m), and in rulings and other guidance issued by the IRS. Generally, members of a Controlled Group share a certain level of common ownership. Members of an Affiliated Service Group may share common ownership and/or a service relationship. For purposes of minimum coverage testing, it's extremely important that your testing account for all employees of the employers in the Controlled or Affiliated Service Group. If you're not sure of your Controlled Group status, contact your plan's legal counsel or consultant and reach out to your Manulife John Hancock representative for assistance from the benefits consulting group.

In certain circumstances, special rules may apply to the Minimum Coverage Test. Some rules are mandatory for employers in a Controlled Group of Businesses or an Affiliated Service Group. Others are optional and can be used to help your plan satisfy the testing requirements.

Permissive disaggregation and the IRC Section 401(k)(3)(F)/401(m)(5)(C) rule

As addressed in the otherwise excludable employees section, a plan allowing for earlier participation than the maximum age and service of age 21 and 1 year of service may apply permissive disaggregation and separate the two coverage groups for minimum coverage and nondiscrimination testing. However, an additional option is provided for nondiscrimination testing of the ADP and ACP tests.

The difference allowed is that the ADP or ACP tests may apply the otherwise excludable employees disaggregation, but applicable to only NHCEs not meeting the maximum eligibility age and service. The reason for this is that it automatically deems the ADP and ACP tests passing for the NHCE only otherwise excludable employee coverage group(s), as no HCEs are included in these groups.

Permissive aggregation

Coverage rules allow an employer who sponsors more than one 401(k) plan to aggregate the plans for purposes of ADP/ACP testing, as long as the plans have the same plan year and use the same testing method (current-year/prior-year). Permissive aggregation allows two or more plans to be tested as if a single plan covered all their eligible employees. The plans must be aggregated for minimum coverage testing before they can be treated as a single plan under the ADP or ACP test.

Often, multiple plans must be combined and treated as a single plan in order to meet minimum coverage requirements. In that case, the ADP/ACP tests for the plans must also be done on an aggregate basis. You may elect to aggregate plans from year to year; however, the plans must be treated the same way in both the ADP/ACP and Minimum Coverage Tests for any given plan year.

For example, if two plans maintained by an employer can pass minimum coverage testing separately, but aggregation of the two 401(k) arrangements would enable the plans to pass the ADP test (or fail by a lesser margin), the employer may elect to aggregate the two plans for coverage testing to improve ADP test results, even though the two plans can pass the Minimum Coverage Test separately.

Mandatory aggregation for HCEs

If an HCE participates in more than one plan of the same employer, the deferral amounts in all the plans are added together when determining the HCE's average deferral ratio for each plan. The same rule applies to matching or after-tax amounts (if applicable) for an HCE who participates in more than one plan of an employer. The mandatory aggregation rule applies even if the plans aren't permissively aggregated for nondiscrimination testing purposes.

Substantiating compliance of certain minimum coverage and nondiscrimination requirements transition rule

In certain circumstances, plans can obtain limited relief for part of the administrative burden associated with complying with minimum coverage and nondiscrimination requirements. IRS Revenue Procedure 93-42 provides for several applications, which rely on data or demonstrations of compliance with minimum coverage or nondiscrimination with IRC Section 401(a)(4) (rate-group testing of nonelective contributions or benefits, rights or features), or nondiscrimination in regard to alternative definitions of compensation under Treasury Regulation Section 1.414(s) requirements, for up to a three-year period. For example, testing conducted for a plan year ended December 31, 2023, may, if proper conditions exist, be relied on through the next two testing periods, in which case the next plan year for required testing would be the 2026 plan year. This application isn't available for use in relieving ADP/ACP testing obligations.

To rely on testing from a previous period in a successive year, generally, the demonstration (and the data on which it's based) must be considered substantially unchanged, and therefore reasonably expected to yield the same results. To meet minimum coverage requirements by relying on a previous testing period's testing, the demographics, census numbers, compensation and financial data, plan provisions, and business entity form (ownership and type of organization) must remain substantially consistent. The use of this substantiation relief depends on a facts and circumstances conclusion for which the previously mentioned criteria and other relevant factors (such as the size of the passing margins of the test relied on) should be examined to render a reasonable determination of validity. There are many issues to consider when contemplating the use of this application. Please contact us to discuss the circumstances under which this option might be available.

Other substantiation uses

The substantiation guidelines can provide relief in other circumstances, particularly in situations where the collection of data is more labor-intensive. When data collection is burdensome and precise data is difficult to obtain at a reasonable cost, the substantiation rules allow for the use of qualified replacement data to demonstrate compliance with the same nondiscrimination requirements mentioned in the previous section. To rely on substantiation quality data, you have to be able to reasonably conclude that the results of the applicable test wouldn't be materially different from those obtained when utilizing precise data.

Another provision of the substantiation guidelines allows reliance on snapshot testing. Snapshot testing is based on an abbreviated period of less than a plan year, provided the data collected for the short period is reasonably representative of the full testing period. When relying on an abbreviated period (snapshot period) for minimum coverage or IRC Section 401(a)(4) testing (the latter incorporates the principles of 410(b)), if the arrangement being tested is subject to an employment or service condition that can't be established fully during the interim period (e.g., a last day of employment requirement for an allocation), higher passing parameters are required and are adjusted at 5% to 10% of the established parameter.

Transition relief

Substantiation relief, as covered above, isn't available if a corporate transaction occurs that changes the configuration of a Controlled Group, ownership status, or demographic census data required to be tested. Certain nondiscrimination and minimum coverage testing obligations are deemed to have been met for the year of and the subsequent testing period following a corporate change that meets certain requirements. A corporate change can generally be described as a transaction involving the acquisition or disposition of an employer or employees of an employer, a merger, or a significant change in ownership of an employer. The term employer includes any related employers within a Controlled Group of Businesses.

Under IRC Section 410(b)(6)(C), this transitional relief from the Minimum Coverage Test is provided for transactions meeting the above description as long as two other conditions are met. First, a plan must meet the requirements of IRC Section 410(b) immediately prior to the transaction. Second, there can't be any significant coverage change other than one that's a direct result of the transaction. No other coverage changes can be enacted, such as excluding a classification of employees or other significant changes. The only change allowed under this relief is the extended coverage of the acquired employees resulting from the acquisition or merger.

IRS Revenue Ruling 2005-11 extended the application of transition relief to nondiscrimination testing under IRC Section 401(a)(4), since it's based on the principles of 410(b) (minimum coverage rules). Provided a plan is subject

to circumstances meeting the criteria described above, Section 401(a)(4) requirements can be deemed satisfied for the same transition period as minimum coverage. However, in addition to a significant coverage change precluding the use of this option, plans seeking relief from Section 401(a)(4) in transition periods can't experience a significant change in benefit levels, or the transition relief will prematurely expire on the effective date of such a change. For example, Corporation A maintains a defined benefit plan (Plan A). Effective May 1, 2025, Corporation A acquires Subsidiary X from Corporation Y. Due to significant cost increases, Plan A is amended to decrease the level of benefit accruals for Subsidiary X employees, effective January 1, 2026. Plan A's Section 401(a)(4) testing transition period ends on December 31, 2025, and must provide testing for the 2026 testing period.

Disaggregated plans method

Plans may decide to completely disaggregate the otherwise excludable portion of the plan, as if each group participates in a separate plan. A separate ADP/ACP test is performed for each disaggregated plan.

Top Heavy test—IRC section 416

To enforce the basic premise that pretax retirement benefit savings accumulation applies to general employees, top heavy testing is conducted in advance of each plan year. A top heavy plan is generally one in which more than 60% of total plan assets are allocated to the accounts of Key Employees. All your plans are generally aggregated or combined to determine top heavy status, including terminated plans. Plans that satisfy the ADP/ACP safe harbor requirements are deemed to pass the Top Heavy Test only if the sole employer contributions funded for a plan year are those meeting the ADP/ACP safe harbor arrangements.

The top heavy determination made at the end of the preceding plan year establishes whether your plan is considered top heavy for the next plan year. Top heavy plans are subject to minimum vesting and contribution requirements. Determining top heavy status in advance allows you to satisfy the minimum contribution requirement through employer contributions, or an additional contribution to Non-Key Employees within the deduction time frame.

Determination date

All top heavy determinations, including whether an employee is a Key Employee and the account balances used to perform the Top Heavy Test, are based on the data for the determination year. Usually, the determination date is the last day of the prior plan year. However, for the first plan year, the determination date is the last day of that year.

Values included in the top heavy ratio

In general, only contributions actually made by the end of the plan year are included in the top heavy ratio (i.e., cash basis). Catch-up contributions are disregarded for the plan year in which they're made. However, those made for prior plan years are taken into account.

Certain distributions made during the plan year are added back and included in a participant's account balance to determine the top heavy ratio. The look-back on distributions applies to both terminated participants who received distributions (including partial distributions, if applicable) and have at least one hour of service during the plan year, and current participants who took in-service distributions.

The look-back period is extended to five years for in-service distributions (distributions made for reasons other than termination, death, or disability). Excess contributions, excess aggregate contributions, and excess deferrals are considered to be in-service withdrawals and, as such, are subject to the five-year look-back rule.

Employees excluded from the Top Heavy Test

- **Accounts of former employees that are still in the plan—**If a participant terminates employment and elects to leave their account in the plan indefinitely, the top heavy ratio only includes their account if they've been credited with one hour of service during the look-back year.
- **Key Employees—**Former Non-Key Employees and distributions to a former Key Employee are excluded from the top heavy ratio. An employee who hasn't performed services for the employer at any time during the one-year period ending on the determination date isn't taken into account for the Top Heavy Test.

Plans considered in the Top Heavy Test

In general, the top heavy determination must be made with regard to all plans maintained by an employer. If you maintain more than one plan, the plans must be aggregated for determining top heavy status if they're part of a required aggregation group. If the plans aren't part of a required aggregation group, you can test them separately. You can also permissibly aggregate them into the group under certain circumstances.

If a required aggregation group's top heavy ratio exceeds 60%, every plan in the group is considered top heavy, even if the plan wouldn't be top heavy if examined separately.

Required aggregation group

A required aggregation group consists of:

- Each plan in which at least one Key Employee benefits

- Any other plan that enables the plan with the Key Employee to satisfy nondiscrimination testing under IRC Section 401(a)(4) or coverage testing under IRC Section 410(b)

Permissive aggregation of plans

In certain circumstances, plans may be combined to satisfy the Top Heavy Test. Plans may be aggregated if:

- They're not required to be aggregated due to the required aggregation rules above.
- The aggregated plans satisfy nondiscrimination testing under IRC Section 401(a)(4) and coverage testing under IRC Section 410(b) if aggregated and considered together.

Participation in a defined contribution and a defined benefit plan

Some plans or features may be disaggregated for nondiscrimination or coverage testing purposes. Disaggregation of a defined benefit plan and a defined contribution plan isn't permitted for top heavy purposes. If you currently maintain a defined benefit plan, or have maintained one within the past five years, please contact your Manulife John Hancock representative to seek guidance regarding the factoring of the plans together.

Important regulatory considerations for the Top Heavy Test

- **Union employees—**In some cases, the top heavy minimum contribution requirement may not apply to union employees. The exception to the minimum contribution requirement applies if the employee is covered by a collective bargaining unit in which retirement benefits were subject to good-faith bargaining between the employee representatives and the employer(s). It applies even if union employees are part of a top heavy plan that also covers non-union employees.
- **Loans that have been deemed distributed—**Plan balances for top heavy purposes include loan balances, including those that have been deemed distributed but not yet offset.
- **Related rollover—**Amounts rolled into a plan are only considered in the top heavy ratio if the distribution is a related rollover. A related rollover is a rollover or transfer that's either made to another plan maintained by the same or related employer or made without the participant's election (such as a transfer made as a result of a merger of two plans).

  Related rollovers aren't included in the distributing plan's top heavy determination. They're included in the recipient plan's top heavy ratio.

- **Unrelated rollover—**Unrelated rollovers are rollovers or transfers that are elected by the participant and made to a plan maintained by an unrelated employer. The plan making the distribution treats the unrelated rollover like any other distribution and includes the amount if the distribution is made within one year of the determination date, or five years for in-service withdrawals. The plan receiving the unrelated rollover excludes the participant's rollover account from its top heavy ratio.
- **Qualified domestic relations order segregated balances and distributions to alternate payees—**If a qualified domestic relations order (QDRO) requires a portion of a participant's balance be segregated, this balance is still included in the participant's balance when the test is run. If a distribution is paid as a result of a QDRO to a spouse, former spouse, or other alternate payee, it's subject to the five-year look-back rule and should be added back to the participant's balances as would any other in-service withdrawal.
- **Segregated balances for beneficiaries and distributions to beneficiaries—**Balances of deceased participants remain connected to the deceased participants' accounts, even if they've been segregated into separate accounts for the beneficiaries. These balances should be included only in the Top Heavy Test based on the determination date that occurs in the plan year in which the participant died. Similarly, distributions to beneficiaries will be added back to the deceased participant's balances for the plan year in which the participant died (after that, the participant fits the employees who don't count definition, as explained above, and is excluded from the test).

Failing the Top Heavy Test correction requirement

In general, failing top heavy statuses are determined in advance of the plan year to give you advance notice of the employer contribution funding necessary for the applicable plan year, as well as time to consider any plan design changes. The top heavy minimum correction contribution for Non-Key Employees, employed on the last day of the top heavy plan year, is the lesser of: (1) a minimum of 3% of full-year gross compensation through employer-funded contributions, or (2) the highest total benefit rate of a Key Employee. For the latter evaluation, elective deferrals are included in determining their percentages. All standard employer contributions are considered when evaluating the minimum benefit level of each Non-Key Employee and offset the correction amounts (if necessary).

Per SECURE 2.0, starting in 2024, Non-Key Employees who don't meet the statutory maximum eligibility requirements (age 21 and 1 year of service) are excluded from the required top heavy minimum correction contributions.

Catch-up contributions overview

IRC Section 414(v) permits individuals age 50 or older to make catch-up contributions. Catch-up contributions are salary deferral contributions that can be made above the regulatory or plan limit on elective deferrals. They're an optional plan provision, so eligible employees may make catch-up contributions only if they're permitted by the plan document.

Catch-up eligible employees

Any eligible participant who reaches age 50 at any time prior to the end of the calendar year is eligible to make catch-up contributions, even if the plan year ends before the time they actually reach their 50th birthday.

Making catch-up contributions

Only amounts that exceed either a regulatory or plan-specific deferral limit may be treated as catch-up contributions. Likewise, if your plan allows catch-up contributions, any excess over a regulatory or plan-specific limit *must* be treated as a catch-up contribution for participants who meet the age requirement and haven't already reached the annual catch-up limit. Generally, there are three ways catch-up contributions may be made:

1 **Statutory limits—**A participant contributes more than the annual IRS limit for elective deferrals under IRC Section 402(g) ($24,500 in 2026). Or the participant contributes an amount, usually together with other plan allocations, that exceeds the IRC Section 415 annual additions limitation.

2 **Plan limit—**A participant contributes more than a plan-imposed elective deferral limit defined by the employer.

3 **ADP test limit—**If your plan fails the ADP test and excess contributions are due to be distributed to a catch-up eligible participant, the refund must instead be recharacterized as catch-up contributions. Excess contributions may be recharacterized as catch-up contributions only if the participant hasn't already reached the catch-up limit for the year.

Catch-up contribution limit

Catch-up contributions are subject to an annual limit indexed for cost-of-living increases. The limit on catch-up contributions is determined each calendar year, regardless of whether the tests used to determine the amount of catch-up contributions are performed on a plan year or calendar year basis. If a catch-up eligible employee makes contributions that are both in excess of the statutory limits, plan limits, and actual deferral percentage limits described above and in excess of their catch-up contribution limit for the calendar year, there will be an excess amount that must be corrected. If a participant contributes an amount that exceeds the statutory limits, plan limits, and actual deferral percentage limits that are less than or equal to the participant's calendar year catch-up contribution limit, there's no need for correction. The elective deferral contributions (including catch-up contributions) will remain in the plan.

Starting in 2025, SECURE 2.0 Section 109, super catch-up contributions, permits higher limits for plan participants who turn ages 60 to 63 within the calendar year. Super catch-up limitations increase the limit by 150% and are indexed annually by Congress, like the standard catch-up limitations. See the Benefit and contribution limits section for the 2026 catch-up limits.

Effect on compliance testing

Catch-up contributions aren't included in the IRC Section 415 limit, plan limit, or ADP tests. They're also not included when determining current-year contributions for Key Employees for top heavy testing. If a catch-up contribution is recognized as a result of contributions made in excess of the deferral limit for the calendar year ($24,500 for 2026), these tests will only take into consideration salary deferrals that haven't been identified as catch-up contributions.

For example, a catch-up eligible participant contributes $31,000 to a plan with a December 31, 2025, plan year end. The $31,000 contribution is comprised of $23,500 (the 2025 deferral limit), plus $7,500 (the 2025 catch-up contribution limit). The $7,500 in catch-up contributions won't be considered in the plan limit, Section 415, or ADP tests. If the same participant contributed only $23,500 during the 2025 plan year, the plan limit, Section 415, and ADP tests would be performed using the total $23,500 contribution. Should the plan fail the ADP test, the participant has the $7,500 catch-up contribution limit available to recharacterize excess deferrals as catch-up contributions and correct the failed ADP test. See the Correction methods—ADP/ACP test for an example.

Elective deferral contributions that are greater than the catch-up limit must be corrected according to the method(s) described in the Correction methods section of this guide.

If your plan allows catch-up contributions, we'll calculate the correct catch-up amounts for participants based on regulatory and plan-imposed limits to ensure the correct amounts are excluded from testing. If your plan fails the ADP test and your plan allows for catch-up contributions, we'll automatically recharacterize any excess contribution amounts for catch-up eligible HCEs as catch-up contributions, to the extent those

deferral amounts haven't already reached the catch-up limit in effect for the calendar year in which the plan year ends.

Catch-up contributions for non-calendar year plans

Catch-up contributions for non-calendar year plans are determined each plan year for any compliance tests performed on a plan year basis (plan year limit tests, Section 415 test, and ADP test) and on a calendar year basis for the IRC Section 402(g) test. Elective deferrals contributed above the limit for the calendar year for a catch-up eligible employee are treated as catch-up contributions until the participant's calendar year catch-up contribution limit is reached. At the end of the plan year, catch-up contributions reduce the amount of elective deferral contributions used in the Section 415, plan limit, or ADP tests, just as in the examples above for a plan using a calendar year for its plan year.

Catch-up contributions for a non-calendar year plan are more difficult to determine because the plan year tests are performed using salary deferral contributions that may include contributions from more than one calendar year. The calendar year determines the amount of catch-up contributions available to each participant; however, these contributions are often determined by compliance tests that account for contributions made across calendar years.

Correction timing and penalties

Note: All corrections must be approved by an authorized plan representative. Please complete and return the correction authorization to us.

All plans are subject to correcting their testing failures within a timeline described in the IRC. Failure to correct testing failures will result in an operational defect and must be resolved as outlined in the Employee Plan Compliance Resolution System (EPCRS) (see Correcting disqualifying failures). To avoid potential operational defects, please see the specific correction method and timing requirements for each test.

In some cases, there are different methods to correct a failed test. You'll need to choose which correction method best meets the overall objectives of your retirement plan and consider the tax ramifications to your participants. While we'll explain your testing results and identify correction methods, it's **your responsibility** as the plan sponsor and administrator to ensure the plan operates within the qualification requirements.

Excise tax period—ADP/ACP test corrections

Correction after a certain date following the plan year end would result in a 10% excise tax on the amount of excess contributions and excess aggregate contributions distributed by the plan. This excise tax is imposed on the employer. Plans may be subject to one of two dates for this purpose:

1. **Plans without an Eligible Automatic Contribution Arrangement (EACA)—**If the excess contributions and excess aggregate contributions are distributed **prior to 2½ months after the plan year being tested**, the plan sponsor isn't subject to the 10% excise tax.
2. **Plans with an EACA—**If the excess contributions and excess aggregate contributions are distributed **prior to 6 months after the plan year being tested**, the plan sponsor isn't subject to the 10% excise tax.

Taxation of excess contributions and excess aggregate contributions

Excess contributions and excess aggregate contributions are taxable to the recipient as ordinary income for the tax year in which the distribution was made. Excess contributions and excess aggregate contributions aren't eligible for rollover.

Correction methods

Elective deferral limit—IRC Section 402(g)

To correct an excess salary deferral, the excess deferral amount plus earnings must be distributed to the participant by April 15 of the year following the calendar year for which the contribution is deferred from wages. Any matching contribution related to an excess deferral will be forfeited. The participant must generally include the excess deferrals in their income for the calendar year in which the excess deferrals were contributed, while the earnings (or loss) are included as income (or used to reduce income) for the calendar year in which the distribution is made.

Timing

Excess deferrals, plus earnings, should be returned by April 15 of the year following the year in which the excess deferral was contributed to the plan. If not, the excess is treated as an employer contribution and subject to the plan's withdrawal restrictions. In general, this means that withdrawals of excess deferrals are permitted only when the participant would otherwise qualify for a distribution (at retirement or on termination of employment), and the participant will be taxed on the distribution *both* at the time of the distribution *and* in the year in which the excess deferral was made.

Self-correction

If you don't distribute excess deferrals prior to April 15, you may be able to avoid disqualification through EPCRS. A plan may generally self-correct a violation by distributing the excess deferral within two years after the year in which it occurred. See Correcting disqualifying failures.

Plan contribution limitation

Elective deferral contributions made in excess of a plan limit may be corrected through EPCRS. IRS Revenue Procedure 2008-50 was updated to include the process for this option. A plan limit violation is corrected using the reduction of account balance correction method, in which "excess allocations that are attributable to elective deferrals or after-tax employee contributions, (along with earnings attributable thereto) must be distributed to the participant." The participant will subsequently receive a Form 1099-R for the year the corrective distribution occurred. Any matching allocation associated with the excess deferrals will need to be forfeited to your plan's forfeiture account for future use, based on the provisions in your plan document.

Timing

Contributing in excess of a plan limit may be an operational violation and should be corrected as soon as possible. See Correcting disqualifying failures.

Excess annual additions—IRC Section 415(c)

Complying with IRC Section 415 is a requirement of plan qualification. To avoid disqualification, excess annual additions to participant accounts should be corrected through the EPCRS program.

Your plan document will determine whether corrective distributions of employee deferrals and after-tax contributions are permitted to correct Section 415 violations, or whether a different method is specified. Below are the possible correction methods permitted by the IRC:

- **Distribute pretax contributions and employee after-tax contributions to affected participants—**If your plan allows corrective distributions, any pretax contributions would be taxable to the recipient as ordinary income for the tax year in which the distribution is made. An appropriate gain or loss should be allocated and distributed with the excess amount.
- **Hold excess employer contributions in a suspense account—**Excess employer contributions may be held in a suspense account and then reallocated to participants or used to offset future employer contributions in the subsequent limitation year. The regulations don't allow employer contributions to be distributed to correct a Section 415 violation.
- **Use excess amounts to reduce affected participants' employer contributions—**Excess amounts are used to reduce the affected participants' employer contributions in the following limitation year if the participant is covered by the plan as of the end of the limitation year. If not, the excess amounts must be held in an unallocated suspense account and eventually allocated as described above.
- **Reallocate—**You can reallocate the excess amount to other participants.

Federal tax withholding

Distributions of employee contributions to correct Section 415 violations are subject to federal tax withholding notice and election requirements. Participants can elect not to have federal tax withholding apply or elect to have a certain percentage or

dollar amount deducted when the distribution is processed. Each participant must receive a notice and withholding election form.

Catch-up contributions

Catch-up contributions aren't considered annual additions. If your plan permits catch-up contributions, any excess amounts will be recharacterized as catch-up contributions for participants eligible to make these contributions instead of being refunded, unless they've reached the catch-up dollar limit in effect for the year.

ADP/ACP tests

A plan fails the ADP/ACP test if the average deferral percentages for HCEs (or average contribution percentages) exceed the acceptable range when compared to the averages for NHCEs. Your plan document outlines the methods available to correct excess contributions (ADP test) and excess aggregate contributions (ACP test). There are generally three methods for correcting excess amounts.

1 Returning excess contributions

The most common correction method is to return excess amounts to the HCEs who deferred or received the highest dollar amount of contributions. Returning a portion of an HCE's deferral or employer matching contribution reduces the ADP or ACP of the HCE group.

Corrective distributions that aren't made within 2½ months of the plan year-end are taxable in the year the distribution occurs, and the employer is subject to a 10% excise tax penalty. Form 5330 must be completed and filed with the IRS to pay the penalty on the refund amounts.

If corrective distributions aren't completed within 12 months of the end of the plan year being tested, a qualification failure will occur, and the ADP/ACP test must be corrected under EPCRS. See Correcting disqualifying failures.

Calculating excess distributions

The full method of distributing excess contributions (adjusted for investment gain/loss) to HCEs to correct an ADP or ACP test is done through a two-tiered leveling process. Before leveling begins, the test parameters produce a definitive amount of percentage points by which the HCE group exceeds what's allowed. Those percentage points must be assigned to individual HCEs in the tier I leveling process to determine the full dollar amount (principal) to be applied to the HCE group for corrective distribution.

Tier I leveling

First, the HCE group's actual deferral/contribution percentages are sorted in descending order. The HCE (or HCEs, if more than one HCE has the same percentage) with the highest percentage is reduced, or leveled, until the percentage equals the next highest HCE percentage or until the remaining testing average of the HCE group is reduced to a passing percentage (or the sum of the percentage points assigned equals the total predetermined aggregate amount to be reduced). This leveling process is repeated with the next highest HCE percentage, as necessary.

The corrected percentages associated with the individual HCEs, subject to leveling, are applied to their compensation to determine the dollar amounts associated with the correction. The corrective dollar amounts are added together and represent the total dollar refund assigned to the tier II leveling process.

Tier II leveling

The second step in the calculation allocates the total refund amount to individual HCEs. Returns are allocated among the HCE group based on the highest dollar amount contribution. The HCE group is, once again, sorted in descending order, based on the highest amounts contributed. As in the tier I leveling process, the leveling reduces each HCE contribution amount from the highest dollar amount to the next highest. The reduction is applied to each HCE until the total amount determined in the first step is allocated.

The intended purpose of the second tier is to reassign the amounts required to correct a test from those HCEs that had the highest deferral ratios and redistribute that amount to HCEs that contributed the most in terms of dollars. This is deemed to be a fairer correction as HCE groups are determined based on the prior year's compensation; therefore, a large compensation divergence is possible within the HCE group test population in the current year. The belief is that HCEs with lower compensation have a more difficult task to contribute a more substantial amount toward their retirement than HCEs on a higher compensation scale; therefore, the corrections are applied to the more substantial contributors.

Note: The second tier of leveling doesn't, actually, result in a corrected test from a mathematical perspective. However, the IRS states that the test is deemed to pass once the process has been completed.

Example: Excess distribution calculation

HCE ADP = 7.39%

NHCE ADP = 3.95%

HCE ADP = the greater of:

- (3.95% x 1.25) = 4.94% or
- The lesser of (3.95% x 2 or 3.95% + 2%) = 5.95%

Maximum HCE percentage allowed = 5.95%

Current HCE ADP = 7.39%

The net disparity, or difference, to be bridged between the HCE and NHCE averages is -1.44%. This reduction will bring the HCE average down to 5.95% so that the test passes.

NHCE ADR = 3.95%

Correction to HCE ADR needed = (1.44% reduction) to reduce HCE ADR to 5.95%

1.44 x 4 (participants) = 5.76 points to reduce

	Compensation	401(k)	ADR
HCE A	$200,000	$12,000	6.00%
HCE B	$150,000	$12,000	8.00%
HCE C	$95,000	$9,500	10.00%
HCE D	$90,000	$5,000	5.56%
Total/average		$38,500	7.39%

Tier I leveling

	Compensation	401(k)	Original ADR	Corrected ADR	Correction amount
HCE C	**$95,000**	**$9,500**	**10.00%**	**6.12%**	**($3,686.00)**
HCE B	**$150,000**	**$12,000**	**8.00%**	**6.12%**	**($2,820.00)**
HCE A	$200,000	$12,000	6.00%	6.00%	
HCE D	$90,000	$5,000	5.56%	5.56%	
Totals/average		$38,500	7.39%	5.95%	**($6,506.00)**

The HCE group is sorted in descending order, beginning with the highest ADR. The HCE ADRs are reduced in a leveling process, either by monitoring the corrected group average or the aggregate basis points to be returned. In this example, 5.76 points need to be returned, or the corrected ADP must be 5.95%. HCEs C and B were leveled, with C initially reduced to 8% (the ADR of HCE B), with a subtotal of 2% corrected. Since both HCE C and B are now at 8%, the remaining 3.76 points to be corrected should be split and reduce their percentages to a net 6.12%. Since it wasn't necessary to reduce further, HCE A is never subject to a reduction in percentage in the tier I leveling. The difference between the original ADR and the corrected ADR for each applicable individual is multiplied by the respective compensation to yield a correction amount. The total, $6,506.00, is then applied to tier II leveling.

Tier II leveling

	Compensation	401(k)	Original ADR	Correction amount	Net contributions allowed
HCE A	**$200,000**	**$12,000**	**6.00%**	**$3,002**	**$8,998.00**
HCE B	**$150,000**	**$12,000**	**8.00%**	**$3,002**	**$8,998.00**
HCE C	**$95,000**	**$9,500**	**10.00%**	**$502**	**$8,998.00**
HCE D	$90,000	$5,000	5.56%		$5,000.00
Totals/average			7.39%	**$6,506**	$17,996.00

The total required distribution amount resulting from the tier I leveling process is now applied in the same manner in the second tier of leveling, now reducing on the criteria of the highest dollar amount contributed. This reduction in contributions continues until the entire contribution amount determined in the tier I leveling has been assigned to an HCE as a corrective distribution. The HCE group is re-sorted in descending order based on the amounts contributed. HCEs A and B are initially reduced to $9,500 and leveled to HCE C, accounting for $5,000 of the $6,506 that must be returned. The remaining $1,506 is split between HCEs A, B, and C to account for the final correction amounts. Since the remaining correction amounts never approached the $5,000 contributed by HCE D, HCE D wasn't subjected to the corrective process.

Catch-up contributions

If your plan allows catch-up contributions and operates on a calendar year, any excess amounts for HCEs will be recharacterized as catch-up contributions—rather than refunded— so long as the HCE is eligible to make catch-up contributions and hasn't reached the catch-up dollar limit in effect for the year. Non-calendar year plans will be reviewed and options provided.

Effective January 1, 2026, SECURE 2.0 Section 603 requires certain employees who meet the prior year compensation level criteria to have catch-up amounts classified as Roth contributions. Recharacterization of corrective distribution deferral amounts, applying to Section 603, will be applicable beginning in 2026.

Federal tax withholding

Distributions to correct a failed ADP or ACP test are subject to federal tax withholding notice and election requirements. Participants can elect not to have taxes withheld or elect to have a certain percentage or dollar amount deducted when the distribution is processed. Each participant must receive a notice and withholding election form.

2 Corrective contributions

Your document may permit qualified nonelective contributions (QNECs), which are allocated to all eligible NHCEs, or qualified matching contributions (QMACs), which are made only to those NHCEs who deferred during the plan year. QNECs and QMACs are usually available only as a correction method when the current-year testing method is used. Both types of qualified contributions must be 100% vested and are subject to additional withdrawal restrictions.

QNECs and QMACs are generally allocated in specific amounts to increase the ADP or ACP percentages of the NHCEs and are subject to the allocation formula outlined in your plan document. The portion of any qualified contribution used to correct the ADP test can't be used to correct the ACP test.

Restricted use of targeted contributions

Your document may also allow for a targeted QNEC or QMAC, which provides a contribution to a smaller number of employees. In prior years, plans could allocate corrective contributions to employees with the lowest income first. Corrective allocations were typically funded to individual employees to the extent that the NHCE group's contribution percentages increased to correct a failing ADP/ACP test. Currently, the use of targeted contributions is restricted and requires corrective contributions to a larger portion of employees. The following allocation restrictions apply to corrective contributions:

- **Disproportionate contributions—**QNECs can't be taken into account in the ADP or ACP test to the extent they exceed the greater of 5% of a participant's compensation or two times the plan's representative contribution rate (either the lowest contribution rate of an NHCE, when evaluating 50% of the eligible NHCEs, or the lowest contribution rate of all the eligible NHCEs employed on the last day of the applicable plan year).
- **Disproportionate matching contributions—**Matching contributions (or QMACs as a corrective contribution) can't be taken into account under the ADP or ACP tests to the extent they exceed the greater of: 5% of a participant's compensation, 100% of the employee's elective deferrals for the testing year, or the product of two times the representative matching rate times the employee's elective deferrals for the year. A plan's representative matching rate is determined by dividing the match contributions by the employee's elective deferrals for the plan year. If the plan allocates different match rates for different rates of deferral (a tiered match—for example: 100% of the first 3% of deferrals, 50% of the next 2% of deferrals), the assumed 401(k) deferral is 6% of compensation for all relevant employees.

3 Recharacterization of 401(k) deferrals as employee after-tax contributions

For plans that include after-tax employee contributions, the ADP test may be corrected by recharacterizing an HCE's pretax deferrals as after-tax contributions rather than distributing them to the participant. The recharacterized contributions are then tested under the ACP test, as if they were part of the 401(m) arrangement.

To use this method, pretax deferrals must be recharacterized within 2½ months of the end of the plan year being tested. In addition, affected HCEs must be notified within this period that the taxable status of their contributions has changed, and they must include these amounts as additional taxable income on their tax returns for the tax year in which the amounts were originally deferred.

This method is often not advisable, as it jeopardizes ACP testing and requires adjusted tax reporting to the IRS.

Minimum Coverage Test—IRC Section 410(b)

If the test initially fails, your plan document may describe the available correction method(s). Most methods usually include expanding the number of NHCEs who receive a contribution. To correct a minimum coverage test failure, generally, the ratio of NHCEs benefiting in the money type arrangement must increase. If the failure involves an elective money type, such as 401(k) elective deferrals or matching contributions, expanding the coverage may require additional corrective contributions to address the unavailability of affected employees to participate. If you're relying on the average benefits test, the correction option may involve adjusting benefits, depending on the nature of the failure, but that's an infrequent situation. Below are the most common correction options. Please keep in mind that your plan document may require a specific method or may leave correction options open to all those allowed by the regulations.

- **Safety valve language/correction—**Your plan document may adhere to a simplified correction method that requires expanding coverage according to a specified formula. For example, previously non-benefiting NHCEs, such as those not employed on the last day of the plan year, may retroactively benefit according to criteria set in your plan, until your plan passes the Minimum Coverage Test. The criteria may require expanding coverage by adding NHCEs according to the most recent separation date. For example, NHCEs would benefit, retroactively, only if they were the next in the sequencing established in the document. Once the ratio percentage test passes, the additional corrections cease. If your document doesn't already contain this language, the only way to address this type of correction would be through a retroactive amendment.
- **Retroactive amendment under Treasury Regulation 1.401(a)(4)-11(g)—**The regulations allow for a more customized correction that may be appropriate when the failure is caused by a large change to the employer's workforce, such as a merger/acquisition or disposition. In this situation, plans can adopt a retroactive amendment to correct a minimum coverage failure, as long as the amendment is adopted within 9½ months following the end of the applicable plan year and the nature of the correction calls for expanding benefits on a permanent basis in a substantial amount. Generally, this is accepted to mean that a targeted correction of minimum benefits, which can't truly be obtained, by the NHCEs should be sought. An example of this would be expanding coverage to lower-paid NHCEs who are in terminated employment status and aren't vested for the employer allocation, so they can never obtain the additional benefits.
- **Retroactive amendment under EPCRS—**The IRS correction program contains a measure to correct a demographic failure when a minimum coverage failure extends beyond the 9½ correction period, as allowed in Treasury Regulation 1.401(a)(4)-11(g). Generally, the correction premise is the same; however, it's addressed through a formal filing to the IRS as part of the Voluntary Correction Program. See Correcting disqualifying failures.

Requirements for top heavy plans—IRC Section 416

In general, top heavy status is determined as of the last day of the prior plan year. Top heavy plans are subject to minimum vesting and contribution requirements.

Top heavy accelerated vesting requirement

Top heavy plans must vest all employer contributions at least as rapidly as one of the schedules below. Your document already accounts for the accelerated vesting requirement, so no further action is required.

- **Six-year graded vesting—**Employees become 20% vested after two years of service, increasing 20% per year thereafter, with 100% after six years.
- **Three-year cliff vesting—**Employees are 0% vested until they complete three years of service, at which point they become 100% vested.

Top heavy minimum contribution requirement

Top heavy plans must generally make a minimum employer contribution of the lesser of (1) 3% of plan-year gross compensation, or (2) the highest benefiting rate of a Key Employee, to every eligible Non-Key Employee. The following rules also apply to minimum contributions:

- The highest contribution rate for each Key Employee includes their 401(k) elective deferrals. No minimum contribution is required for a plan year in which no deferrals or contributions are made to any Key Employee.
- All employer contributions, already allocated to participants, may be used to satisfy the 3% contribution requirement. If the plan makes a profit sharing or matching contribution greater than 3% of compensation each year to all Non-Key Employees, no additional contributions are needed.
- Minimum contributions must be made, at least, to all eligible Non-Key Employees who were employed at the end of the plan, regardless of other employer contribution allocation requirements (such as minimum hours served in the plan year). Key Employees may also receive these contributions. Starting

in 2024, Non-Key Employees who don't meet the statutory maximum eligibility requirements (age 21 and 1 year of service) are excluded from the required correction benefits of top heavy minimum contributions.

- Corrective contributions must be made according to the normal deductibility timelines and annual addition rules.
- Corrective contributions made to satisfy other nondiscrimination or coverage requirements may also be used to satisfy the top heavy minimum contribution requirements. This includes ADP/ACP corrective QNECs or QMACs.

Catch-up contributions

Catch-up contributions have no impact on the applicable percentage for the rate of the required minimum contribution when the highest contribution percentage for a Key Employee is less than 3%. These contributions are also not taken into account when determining the highest Key Employee deferral rate.

Matching contributions

Matching contributions can be used to meet the minimum contribution requirement (generally 3%). Any eligible Non-Key Employee who didn't receive a minimum allocation from a matching contribution because they didn't make any salary deferrals during the year must be credited with a minimum contribution through an additional allocation.

ADP/ACP safe harbor plans

A plan that meets the ADP safe harbor requirements of IRC Section 401(k)(12) is automatically deemed not to be top heavy if no other employer contributions were made. The plan will also be deemed not to be top heavy if matching contributions satisfy the ACP safe harbor requirements.

Timing

Minimum contributions must be allocated by the due date of the employer's corporate tax return, including extensions, to be deductible.

Catch-up contributions

By definition, catch-up contributions only occur as a result of salary deferral contributions exceeding the statutory IRC Section 402(g) limits, plan deferral limits, or ADP test failures, where corrective distributions can be recharacterized as catch-up contributions. If a participant's catch-up contributions exceed the limit for that year, you should distribute the excess amount to them, as an elective deferral IRC Section 402(g) limit failure. See Catch-up contributions overview for more information about these contributions.

Traditional safe harbor arrangements

IRC Section 401(k)(12) provides a design-based structure by which a 401(k) plan can be deemed to pass the ADP nondiscrimination test. The top heavy rules may also be automatically satisfied for top heavy plans. To qualify as a safe harbor 401(k) plan, a plan must satisfy these four requirements.

1 Safe harbor contribution

The employer must make either a safe harbor matching contribution or a safe harbor nonelective contribution, and it must apply to at least all eligible NHCEs who meet the statutory maximum eligibility requirements. The plan may—but isn't required to—provide the safe harbor contribution to eligible HCEs. Allocation conditions, such as a last-day or minimum hours requirement, may not be applied to safe harbor contributions. The contribution formula must be based on a proven nondiscriminatory definition of compensation.

Here are the types of safe harbor contributions that can be made.

- **Safe harbor matching contribution**

  A plan meets the safe harbor matching requirements if the matching contributions are made in an amount equal to a minimum of 100% of elective deferrals, equaling a net 4% of compensation, within the first 5% of compensation. There are several rate combinations that would satisfy this requirement, but they're limited to several other restrictions, including:

  - The rate of matching can't increase as the rate of deferral increases.
  - All participants must receive a uniform rate of match.
  - It may be applied on a plan-year basis or on a payroll-period basis. If the contribution is determined on a plan-year basis, the contribution formula must compute the rates using compensation and 401(k) deferrals for the entire plan year. The timing of the contributions is based on the normal deduction timelines.
  - If the formula is applied using a measurement period less than annual, the match is determined using the employee's compensation for the applicable period, but the funding must occur by the end of the quarter following the quarter in which the measurement period ended. For example, a monthly safe harbor match made in April would have to be funded no later than the last day of September.

  Basic matching formula under Section 401(k)(12)

  The basic formula is: 100% match on the first 3% of compensation deferred, plus 50% match on the next 2% of compensation deferred. The maximum match that's required under the basic formula is 4% of compensation (100% of deferrals up to 3% of compensation, plus 50% of deferrals between 3% and 5% of compensation). This match would apply to any participant who defers at least 5% of compensation.

  Enhanced matching formula under Section 401(k)(12)

  An enhanced formula is one that provides a greater match than the basic match formula at any level of deferral. Elective deferrals that are matched under the enhanced formula don't have to be limited to a certain percentage of compensation to satisfy the ADP safe harbor contribution requirement.

- **Safe harbor nonelective contribution**

  A safe harbor nonelective contribution satisfies the contribution requirement if it equals at least 3% of the employee's compensation. As with the match, the nonelective contribution needs to be provided only to eligible NHCEs. A contribution greater than 3% is also permitted. An eligible NHCE must receive the nonelective contribution regardless of whether they choose to make deferrals under the 401(k) arrangement.

  A plan with matching contributions (other than safe harbor matching contributions) that uses the safe harbor nonelective contribution method for satisfying the ADP test may also satisfy the ACP test if the matching contributions meet the following requirements:

  - Matching contributions aren't made with respect to salary deferral contributions (or employee contributions) that in the aggregate exceed 6% of compensation, and discretionary (non-safe harbor) matching contributions don't exceed a dollar amount equal to 4% of an employee's salary.
  - The rate of matching contributions doesn't increase as the rate of salary deferral contributions or employee contributions (after-tax employee contributions) increases.
  - At any rate of salary deferral or employee contribution, the rate of matching contributions for an HCE isn't higher than the rate for an NHCE.
  - The salary deferral or employee contributions can't be unduly restricted.

2 Vesting

Contributions must be 100% vested, regardless of the employee's length of service.

3 Withdrawal restrictions

Participant withdrawals of safe harbor contributions are subject to the same withdrawal restrictions that apply to elective deferrals. In general, safe harbor contributions can't be distributed from the plan prior to age 59½ unless the participant separates from employment. Safe harbor contributions aren't available for hardship withdrawal prior to age 59½.

4 Annual notice requirement

To satisfy the safe harbor requirements, a plan must provide eligible employees with an annual written notice that describes the employees' rights and obligations under the plan. The notice must be provided to employees between 30 and 90 days before the beginning of the plan year.

Some plans may offer a contingent safe harbor contribution, with the ability to amend the plan into a safe harbor plan as late as 30 days prior to the end of the plan year. To implement a contingent safe harbor provision, the employer must provide a contingent safe harbor notice to employees. The notice would indicate that the employer might amend the plan to provide a nonelective contribution to satisfy the ADP test for that year, and employees will be notified in the event of such an amendment.

If the employer elects to provide a safe harbor nonelective contribution, a supplemental notice must be provided to eligible employees no later than 30 days before the end of the plan year. The supplemental notice can be a separate notice, or it can be included in the next plan year's safe harbor or contingent notice.

Qualified automatic contribution arrangement

IRC Section 401(k)(13) offers an alternative safe harbor, but it's only available to plans that have an automatic enrollment feature and can satisfy the definition of a qualified automatic contribution arrangement (QACA). Certain qualified automatic enrollment plans that satisfy the requirements of IRC Section 401(k)(13) may be exempt from ADP/ACP testing, and, in some cases, top heavy testing.

Automatic enrollment

Participants are treated as having made the default deferral election unless they specifically elect not to have such contributions made or choose a different deferral percentage. Employees must be initially enrolled at a rate between 3% and 10% of compensation. Deferral contributions must automatically increase annually by 1% after the first full plan year if the initial rate is less than 6% of compensation.

QACA safe harbor contribution requirement

There are three contributions that can satisfy the QACA requirements.

1 **Basic matching formula under Section 401(k)(13)—** The basic formula for a QACA is: 100% match on the first 1% of compensation deferred, plus 50% match on the next 5% of compensation deferred. Therefore, the required match is 3.5% of compensation and is spread out over deferrals equaling 6% of compensation.

2 **Enhanced matching formula under Section 401(k)(13)—**Similar to the 401(k)(12) safe harbor requirements, the QACA safe harbor requirements allow for an enhanced matching formula that's no less than the matching contribution an employee would receive under the basic formula at any rate of deferral. The rate of match for HCEs may not be greater than the rate of match for NHCEs at each level of employee contribution, and it can't increase as employee contributions increase. In addition, employee contributions greater than 6% of compensation can't be matched.

3 **Safe harbor nonelective contribution—**A nonelective contribution will satisfy the contribution requirement if it equals at least 3% of the employee's compensation. The nonelective formula requirement is the same for both QACA safe harbor and 401(k)(12) safe harbor plans. The nonelective contribution only needs to be provided to eligible NHCEs, and a contribution greater than 3% is permitted. An eligible NHCE must receive the nonelective contribution regardless of whether the employee is enrolled under the automatic contribution feature, enrolls by affirmative election, or elects not to enroll to avoid automatic enrollment.

Vesting requirement

Both matching and nonelective auto-enrollment safe-harbor contributions are subject to a vesting schedule of two years or less. Safe harbor contributions made under the QACA safe harbor must be 100% vested for any employee who has completed at least 2 years of service. The plan may provide zero percent vesting for an employee who hasn't completed at least 2 years of service, or a higher percentage.

Annual notice requirement

To satisfy the QACA safe harbor requirements, a plan must provide eligible employees with an annual written notice that describes the employees' rights and obligations under the plan. The notice must be provided to employees between 30 and 90 days before the beginning of the plan year. It must describe the employees' right to opt out (or to have contributions made at a different percentage). Additionally, the notice must explain how contributions will be invested in the absence of an investment election by the employee.

Withdrawal restrictions

Participant withdrawals of ADP safe harbor contributions are subject to the same withdrawal restrictions that apply to elective deferrals. In general, safe harbor contributions can't be distributed from the plan prior to age 59½ unless the participant separates from employment. Safe harbor contributions aren't available for hardship withdrawal prior to age 59½.

Ability to satisfy ADP/ACP tests

The use of one of the above allocation methods will automatically satisfy both the ADP and the ACP nondiscrimination test, provided:

- The basic matching contribution formula is used, and no other matching contributions are made to the plan, or
- An enhanced matching contribution formula is used, under which matching contributions are only made with respect to salary deferral contributions that don't exceed 6% of compensation, and either no other matching contributions are made to the plan, or matching contributions (other than safe harbor matching contributions) are made that don't exceed

4% of an employee's salary. The salary deferral contributions can't be unduly restricted in order for the safe harbor matching contribution method to work. Reasonable restrictions include those regarding election periods, the amount of contributions, the types of compensation used, and suspension of the ability to make contributions for a period of time due to a hardship withdrawal.

Safe harbor matching contribution requirements must be met either on the basis of the measurement period or each payroll period. If the payroll period is used, the contribution can't be made later than the last day of the quarter following the quarter in which the elective contributions on which those matching contributions are based were made.

Reducing/eliminating safe harbor matching contributions

Although the safe harbor matching contribution must be determined under a fixed formula, an employer may amend the plan during the plan year to reduce or discontinue the match prospectively for the balance of the plan year and choose instead to run the ADP/ACP tests for that year.

To reduce or eliminate the safe harbor contribution, the plan must provide a supplemental notice to eligible employees at least 30 days prior to the amendment's effective date. The notice must explain the consequences of the amendment, the procedures by which a participant may change their deferral election, and the effective date of the amendment. Participants must be given a reasonable opportunity prior to the suspension of the match to change their deferral election. The reduction or elimination of the safe harbor matching contribution must become effective no earlier than 30 days after the employees have been given the supplemental notice and the date the amendment is adopted. The employer must continue to fund the match with respect to amounts deferred through the effective date of the amendment.

Even though the safe harbor requirements are satisfied through the effective date of the amendment, the elective deferrals made for the entire plan year are still subject to the ADP test, and the safe harbor match contributed on deferrals made through the effective date of the amendment are still subject to the ACP test.

Correcting disqualifying failures

Employee Plans Compliance Resolution System

The Employee Plans Compliance Resolution System (EPCRS) includes three correction programs for operational and plan document errors affecting qualified plans. Each program allows you to correct errors and avoid disqualification, preserving tax deferred benefits for participants. EPCRS covers four types of qualification failures. The category a failure falls under determines the available correction program and appropriate correction method.

1. **Plan document failure—**The IRC and ERISA require the terms of the plan and certain legal requirements to be clearly stated in the plan document. Failure to include required provisions or including a provision that violates qualification requirements may disqualify the plan.
2. **Operational failure—**The plan document provisions should control the actual operations of the plan. An operational failure occurs when a plan doesn't follow the terms of the plan document.
3. **Demographic failure—**A demographic failure occurs when a plan doesn't satisfy coverage, participation, and nondiscrimination requirements, even if it operates according to the provisions of the plan document.
4. **Employer eligibility failure—**Only certain types of employers can sponsor different types of qualified plans. For example, governmental employers aren't permitted to sponsor 401(k) plans, and only tax-exempt organizations can sponsor a 403(b) plan. Employer eligibility failure occurs when an employer maintains a plan that it isn't permitted to sponsor.

EPCRS correction programs

Self-Correction Program (SCP)

The SCP is a self-initiated correction program for resolving operational failures. There are no disclosure requirements or IRS fees associated with the program. Generally, operational failures discovered within two years are eligible for correction through SCP.

The IRS provides specific guidance on using SCP to correct some operational failures, as well as general correction principles for errors without specific guidance. For an error to be considered fully resolved, a plan sponsor must implement policies to ensure compliance with IRS qualification requirements.

Voluntary Correction Program (VCP)

The VCP is a self-initiated program for correcting operational or plan document failures. VCP requires disclosure and payment to the IRS (VCP compliance fee). Employers submitting a formal application through VCP must identify the correction methods used to resolve qualification failures. The IRS will provide relief under VCP through a compliance statement that addresses the failures and the correction methods identified by the employer, including a time period for implementing the corrections. There's no time limit for using VCP. However, a plan can't submit an application to VCP if it's under DOL or IRS Audit.

Audit Closing Agreement Program (Audit CAP)

Audit CAP is used to correct qualification failures identified during an IRS examination that aren't insignificant failures eligible for relief under SCP. For relief under Audit CAP, the employer must agree to correct the violation, pay a sanction, and sign a closing agreement with the IRS. The terms of the agreement and the sanction charged to the plan sponsor can be negotiated with the IRS. However, if the sponsor and the IRS can't reach an agreement, the IRS will proceed with disqualifying the plan.

Note: The determinations regarding the nature of a failure, potential correction methods, the appropriate program, or other considerations involved in the correction process are issues subject to interpretation and legal judgment. We'll suggest certain correction measures when a more routine operational failure occurs, and the correction is straightforward and without controversy. In all cases, we highly suggest conferring with appropriate legal counsel to determine the best course of action.

Glossary

Adoption Agreement—The section of a plan document containing variable plan options, simply formatted for those options to be selected and easily referenced.

Affiliated Service Group —A group of two or more companies related in the performance of services or management functions. Employees of an Affiliated Service Group are generally considered to be working for the same employer and must be taken into account for compliance testing purposes. Please contact your ERISA compliance specialist to learn more.

Authorized signer—Any person designated by the employer or plan sponsor to execute directives regarding plan operation and planning. Individuals may include officers who are delegated specific authorities, such as signing plan documents and other forms, or governing payroll operations and plan participant level authorization (vesting confirmation, etc.).

Board resolution—A legal document authorized by a corporate board of directors that may apply as specific direction in retirement plan management. Requirements for a board resolution may vary with state law.

Catch–up contributions—See Catch-up contributions overview.

Controlled Group of Businesses—Members of a Controlled Group share some degree of common ownership. There are two types of Controlled Groups: Parent-Subsidiary and Brother-Sister.

- **Parent–Subsidiary Controlled Group**

  This version consists of one or more corporations owning a controlling interest in another organization (often a parent company). A controlling interest is defined as ownership of at least 80% of the total combined voting power of all voting stock. For partnerships, a controlling interest means ownership of at least 80% of the partnership's profits or capital interests.

  Example: Partnership A owns 80% of the voting shares of S Corporation B. S Corporation B owns 80% of the profits interest in Partnership C. Partnership A is the common parent of a Controlled Group that includes Partnership A, S Corporation B, and Partnership C.

- **Brother–Sister Controlled Group**

  This version consists of two or more organizations that satisfy both of the following two requirements.

  1 Substantial Ownership Test

  The same five or fewer individuals (or trusts or estates) collectively own a controlling interest (same as for Parent–Subsidiary Controlled Groups) in each applicable organization.

  2 Identical Ownership Test

  Effective control of each organization takes into account the ownership of each individual in each company with shared ownership, only to the extent ownership is identical across companies. More simply, the least amount each individual has in each company is referred to as the individual's Identical Ownership. For example, Owner A owns 20% in Company 1, 35% in Company B, and 65% in Company C. Owner A's identical ownership for this array of companies is 20%, because it's the least amount owned of the companies being evaluated.

  For the Identical Ownership Test to be met, the Identical Ownership for all the individuals sharing ownership in the companies being evaluated must equal at least 50%.

  For a corporation, effective control means owning stock possessing more than 50% of the total combined voting power of all classes of voting stock or more than 50% of the total value of the shares of all classes of stock. For a partnership, owning more than 50% of the partnership's profits or interests.

Delinquent Filer Voluntary Compliance (DFVC)—This program, administered by the Employee Benefits Security Administration (EBSA), provides relief from ERISA and IRC late penalty assessments for plan sponsors who fail to file Form 5500 by the due date. The program generally requires that a specially marked Form 5500 be filed with the EBSA and that a payment be made to the Department of Labor. More information can be obtained on the EBSA website.

Department of Labor (DOL)—This federal department has broad authority to regulate and enforce employment laws, and specifically ERISA law as it pertains to pension, welfare, and other types of benefits programs provided by employers.

Employee Benefits Security Administration (EBSA)—The federal administration agency within the DOL, primarily concerned with employee benefit plans, regulation, and enforcement of ERISA and other pension regulations. It also provides guidance to the administrators of these plans in official technical pronouncements and through informal communications on its website.

Eligibility requirements—The participation requirements specified in the plan document, such as age 21 and 1 year of service.

EPCRS—See Employee Plans Compliance Resolution System.

ERISA (The Employee Retirement Income Security Act of 1974)—Employers are required to design and administer retirement plans in accordance with the regulations issued under this law. It requires proper plan reporting, disclosures to participants and beneficiaries within certain timeframes, minimum participation and minimum vesting standards, and the management and operation of the plan in accordance with the best interests of the participants and beneficiaries.

Fiduciary—Any person who:

- Exercises any discretionary authority or control over the management of the plan
- Exercises any authority or control over the management or disposition of the plan's assets
- Renders investment advice with respect to plan assets for a fee or other compensation
- Has any discretionary authority or responsibility in the administration of the plan (ERISA Sec. 3(21)(A))

Form 5500—This form is required to be filed every year by an administrator of a qualified retirement plan. It contains information about the plan document, the plan's assets, financial transactions on a plan-year basis, the trustee, fees deducted from the plan, and information about the participants and beneficiaries. See the compliance section of our administration manual for more information.

Form 5558—This form is used to file an extension for the Form 5500. The filing can generally be extended up to 2½ months after the regular due date. See the compliance section of our administration manual for more information.

Form 5330—This form is filed with the IRS for a variety of purposes, but it's generally used to report transactions that result in tax penalties to the employer sponsoring the plan. For example, if the plan fails the ADP or ACP test for the plan year, and corrective distributions to the plan's HCEs aren't made within 2½ months of the end of the plan year, the employer is liable for an excise tax that must be submitted with the Form 5330. See the compliance section of our administration manual for more information.

Highly Compensated Employee—See Identification of certain employees.

Key Employee—See Identification of certain employees.

Limitation year—The limitation year is usually the plan year or the calendar year, as defined in the plan document. It's used mainly for the annual additions 415 test.

Matching contribution—An employer contribution based on a formula referencing the level of salary deferrals made by a participant. For example, the matching contribution formula might be defined as 50% of the amount of a participant's deferrals up to a maximum of 6% of plan year compensation.

Multiemployer plan—This is a plan that covers the collective bargaining unit employees of more than one employer or collective bargaining unit employees of more than one Controlled Group.

Multiple employer plan—This is a plan that covers employees of more than one employer or employees of more than one Controlled Group.

Non-Highly Compensated Employees—A Non-Highly Compensated Employee is any employee who's not a Highly Compensated Employee. See Identification of certain employees.

Plan administrator—The plan administrator is generally the employer in a single–employer plan. They're responsible for the day–to–day operations of the plan and for managing its administration.

Plan sponsor—The entity that offers the plan. It's generally the employer for a single-employer plan.

Profit sharing contribution—A type of contribution stated in the plan document, either as a set or discretionary amount, ranging from 1% to 15%. It's generally allocated to eligible participants in proportion to their plan-year compensation.

Qualified domestic relations order (QDRO)—A QDRO is a court order, judgment, or decree, in which an alternate payee, such as the participant's spouse or children, receives the right to plan benefits that otherwise would have been provided to the participant.

Safe harbor 401(k) plan—See Traditional safe harbor arrangements.

Summary Annual Report (SAR)—This is a summary of Form 5500 information that's required to be provided to every participant and beneficiary (who has a right to plan benefits) within 60 days of the due date of the Form 5500 filing.

Summary plan description (SPD)—The SPD describes the major features of the plan document, including the name and type of plan, the names and addresses of the plan administrator and trustee(s), the plan's requirements for eligibility and vesting, a description of the funding medium, and the procedures for applying for benefits. Each participant and beneficiary must be furnished with a copy of the SPD within 90 days after they become a participant, or (if later) within 120 days of the establishment of the plan.

Trustee—The trustee holds title to plan assets and is a fiduciary of the plan. A trustee might have discretion to manage and invest the plan's assets and otherwise manage assets, or they may be a directed trustee, in which case they'd be responsible only for the custody of the plan's assets and for certain administrative or recordkeeping functions.

Voluntary Fiduciary Correction Program (VFCP)—See EPCRS correction programs.

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