

# Non-Discrimination Testing & Corrective Distributions

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

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

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

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

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## What is the non-discrimination test?

There are two non-discrimination tests performed each year.

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

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

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

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## When are corrective distributions required?

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

If you receive a corrective distribution refund check, it is important to note that it is taxable to the employee in the year that the distribution is issued. You will receive a 1099-R to reference when filing your personal tax return.