

2009



UNDERSTANDING 401(k) Nondiscrimination Testing



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As a business, there are some things that need to be done every year: file corporate taxes, reconcile payroll, and have **nondiscrimination testing** performed on the company's **qualified retirement plan**. Transamerica Retirement Services* ("Transamerica") knows that understanding the ever-changing retirement plan regulations can be difficult. We created this guide to help you navigate the ins and outs of qualified plan testing requirements (**nondiscrimination testing**).

While qualified plan testing can seem a bit overwhelming, the good news is that you're not alone. Transamerica Retirement Services or your local third party administrator (TPA) will assist you by determining which tests are required for your plan, performing the necessary testing, and providing you with the test results and options for any needed corrections. So rest easy. We're here to help you keep your plan compliant and on track.

Read on to find out what the various qualified retirement plan tests are and what they mean to your company. We'll use the hypothetical "ABC Company" to illustrate how the various tests work. We've included a list of definitions in the back of this booklet. For your convenience, we have included all defined terms in bold font, so you know when to look at the glossary.

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Here are some facts about the ABC Company:

- Jim Smith is an employee and owns 100% of the ABC Company. Jim's daughter, Janet, is also an employee of the company. According to regulations under the Internal Revenue Code (**IRC**), this means that both Jim and Janet are considered **highly compensated employees (HCEs)** as well as **key employees**. It's important to determine who in your company is an **HCE** since you'll use this information in most of your retirement plan's **nondiscrimination tests**.
- ABC Company's 401(k) plan only covers employees who are at least age 21 and have one year of service (the **eligibility requirements** for the plan).
- Besides Jim Smith and his daughter, Janet, ABC Company has six **non-highly compensated employees (NHCEs)**.
- The following table (Table of Facts) summarizes facts about ABC Company and its **401(k) plan** for the plan year that just ended, which, in our example, is the year 2009. We'll use this information to show some practical examples of some of the **nondiscrimination tests**. This table is typical of the information Transamerica or your TPA needs in order to test your plan.

Table of Facts

“A” Name	“B” Eligible? Y/N ¹	“C” Gross Comp. ²	“D” Salary Deferrals	“E” Deferral % ³	“F” HCE? Y/N	“G” Key Employee? Y/N
Jim	Y	\$ 100,000	\$ 10,000	10%	Y	Y
Janet	Y	\$ 40,000	\$ 400	1%	Y	Y
NHCE #1	Y	\$ 30,000	\$ 1,800	6%	N	N
NHCE #2	Y	\$ 20,000	\$ 0	0%	N	N
NHCE #3	Y	\$ 20,000	\$ 2,000	10%	N	N
NHCE #4	Y	\$ 15,000	\$ 3,000	20%	N	N
NHCE #5	N	N/A	N/A	N/A	N	N
NHCE #6	N	N/A	N/A	N/A	N	N

1. The plan defines eligible employees as those who are at least age 21 and who have worked at least 1,000 hours during a 12-month consecutive period, which equated to a year of service (the **eligibility requirements**).
2. If an employee is not eligible for the plan, columns “C” through “E” are marked “N/A.”
3. Deferral % = salary deferrals divided by gross compensation (“D” divided by “C”).

Why You Need to Test Your Plan

A **401(k) plan** that provides for pre-tax and/or Roth 401(k) elective contributions and/or additional contributions, such as matching contributions, and/or **profit sharing contributions** is subject to special **nondiscrimination tests**. The **IRS** requires that your company's retirement plan demonstrate that it provides comparable benefits to all employees—rank-and-file employees (**NHCEs**) as well as the highly compensated ones (**HCEs**).

How Does it Work?

Transamerica or your local TPA will handle all the compliance testing for your plan. Prior to the testing, you, the plan sponsor, must take these four steps:

- **STEP 1. REVIEW YOUR PLAN DOCUMENT AND PROCEDURES**

As the plan sponsor, determine if any **amendments** were made to the plan that year and see what impact, if any, they may have on the plan's benefits and its demographics. Transamerica or your TPA can help you with this by reviewing your documents and **amendments**. Additionally, go over your administrative procedures to make sure that they follow the **plan document** and **amendments**.

- **STEP 2. DETERMINE THE GROUP STRUCTURE OF YOUR COMPANY**

Are you a member of a **controlled group** or an **affiliated service group**? Your company's status can change from year to year depending on mergers, acquisitions or sales. This is why it's very important that you determine your structure since it affects your data collection and aggregation. Transamerica or your TPA can explain the definitions of the groups and provide some guidance on your company's group structure. Ultimately, it may be necessary to consult outside legal or tax counsel to determine your company's status.

- **STEP 3. COLLECT YOUR DATA**

Having complete, accurate data makes the entire testing process run smoothly and efficiently. The type of data to collect includes plan year **compensation**, hours of work, contribution amounts, and dates of employee birth, hire and termination. Transamerica or your TPA will provide you with a complete list of data requirements. However, if your retirement plan is made available to you through an outsourcing organization, then that organization will collect the data for you.

- **STEP 4. REVIEW ELIGIBILITY AND COVERAGE**

Once plan data is collected, review employees' eligibility for plan participation according to the **eligibility requirements** of your plan documents. As part of this review, make sure you identify who is receiving benefits from your plan.

Types of Tests for Retirement Plans

The number of tests required to be conducted on your plan depends on the type of company you have and the type of **qualified retirement plan(s)** that you offer. The tests should be performed after the close of your **plan year**, after the last pay cycle has been deposited for your **plan year**.

In general, the most common tests include the following (the references are to sections of the **IRC**):

- **Minimum coverage test (410(b))**
- **Compensation test (414(s))**
- **Actual deferral percentage (ADP) test**
- **Actual contribution percentage (ACP) test**
- **Deferral limit test (402(g))**
- **Annual additions test (415 Limit)**
- **Top-heavy test (416)**

It is not uncommon for a plan to initially fail one or all of these tests. If the plan fails any of these tests, corrections must be made before moving on to the next test. Of course, Transamerica will conduct all these tests on behalf of your plan and provide you with options on how to correct any failed test(s). For plans with a TPA firm, that firm will handle the testing and provide you with options on how to handle any corrections needed.

Minimum Coverage Test (410(b))

This test determines whether or not the retirement plan *discriminates* in favor of **HCEs**. The test compares the percentage of **HCEs** benefiting under the plan to the percentage of **NHCEs** benefiting under the plan. This test is performed separately for different types of contributions. For example: A plan with **salary deferrals**, **matching contributions**, and **profit sharing contributions** will be subject to three different coverage tests; one for each type of contribution.

For purposes of the **salary deferral** portion of the plan, a **participant** benefits in the eyes of the IRS, if the employee is **eligible** to make **salary deferrals** whether or not he or she actually does. The employee does not actually have to make **salary deferrals** to benefit from the plan. For matching contributions and profit sharing contributions, the **minimum coverage test** is performed only when a contribution is made.

Under the **minimum coverage test**, the ratio or percentage of **NHCEs** benefiting under the plan must be at least 70% of the ratio of **HCEs** benefiting under the plan.

Minimum Coverage Test in Action for Salary Deferrals

According to the Table of Facts, ABC Company has two (2) **HCEs**, both of whom are eligible to participate in the plan, and six (6) **NHCEs**, four (4) of whom are eligible to participate. Two of the **NHCEs** have not met the plan's **eligibility requirements**, which are the minimum age of 21 and a **year of service**. Now we only need to review whether the number of eligible **NHCEs** benefiting under the plan is at least equal to 70% of the **HCEs** benefiting under the plan. In this case, 100% of the eligible **NHCEs** are benefiting (even though not all of the 4 eligible **NHCEs** are actually making salary deferrals), so the plan automatically passes this test (remember, for purposes of benefiting, an employee just needs to be eligible to make salary deferrals).

Correcting the Problem

If your plan fails the **minimum coverage test**, you may be required to temporarily reduce or permanently change your **eligibility requirements** to pass the test. Transamerica or your TPA will test your **401(k) plan** and will explain the alternatives available.

Compensation Test (414(s))

If your plan provides compensation exclusions, your plan may be subject to the **compensation test**.

Actual Deferral Percentage (ADP) Test and Actual Contribution Percentage (ACP) Test

The **ADP test** applies to **salary deferrals** and verifies that the average deferral percentage of **HCEs** does not exceed the average deferral percentage of the **NHCEs** in excess of the **IRS** permitted differential.

To perform the **ADP test**, Transamerica first determines every employee who is eligible to make a **salary deferral**. It does not matter if the employee actually made a deferral, only whether the employee was eligible to do so. Once this is determined, Transamerica or your TPA will divide the eligibility list into **HCEs** and **NHCEs** and will calculate the average deferral percentage for each group.

*The **ACP test** applies to **matching contributions**. The **ACP test** is performed just like the **ADP test**, except the **ACP test** compares the average percentage of **matching contributions** made on behalf of the **HCEs** to the average percentage of **matching contributions** made on behalf of the **NHCEs**. If the **HCEs'** percentage is greater than the **NHCEs'** percentage, the test will fail unless the difference between the two is within the **IRS** permitted differential.*

ADP and ACP Test in Action

According to the Table of Facts for ABC Company, both of the **HCEs** made **salary deferrals**, as well as three (3) of the four (4) **NHCEs** who met the **plan's eligibility requirements** (**NHCEs** #'s 1, 3, and 4). The **HCEs'** average deferral is 5.5% (the sum of Jim's and Janet's deferral percentages [10% + 1% = 11%], divided by 2 – because there were only two **HCEs**). The **NHCEs'** average deferral is 9%, which equals the sum of the salary deferral percentages of the four **NHCEs** eligible for the plan, which is 36% (6% + 0% + 10% + 20% = 36%), divided by 4. Because the difference between the average deferral percentage of the **HCEs** and the **NHCEs** is within **IRS** limits, the **ADP test** passes. In this case, the **NHCEs'** average deferral percentage was greater than the **HCEs'**, which is always okay.

Correcting the Problem

If the plan does not pass the **ADP/ACP tests**, the test(s) must be corrected. Several correction options may be available, including:

- Re-characterizing the excess contributions as **catch-up contributions**, if permissible
- Making a **qualified non-elective contribution (QNEC)** or **qualified matching contribution (QMAC)** on a timely basis
- Refunding the **excess contributions**

If the plan fails the **ADP/ACP test**, Transamerica or your TPA will present you with all of your options.

Deferral Limit Test (402(g))

Under this test, a **participant's salary deferrals** for a calendar year may not exceed an **IRS** pre-determined annual limit. For 2009, the **IRS** limit is \$16,500. If the **participant's salary deferrals** are more than the annual limit, any amount over the annual limit that cannot be re-characterized as **catch-up contributions** equals the **excess deferrals** that must be returned to the **participant**. For 2009, the limit on catch-up contributions is \$5,500. Therefore, a **participant** who is eligible to make **catch-up contributions** may be able to contribute up to \$22,000 in 2009 (assuming other nondiscrimination tests pass). If the plan allows **Roth 401(k) contributions**, the \$22,000 can be made entirely on a pre-tax basis, entirely on an after-tax basis, or on a combined pre-tax and after-tax basis.

Deferral Limit Test in Action

For ABC Company, the deferral limit test looks at each employee who is eligible for the **401(k) plan** to see whether the employee made **salary deferrals** over \$16,500 (for 2009). According to the Table of Facts, no **participant** made **salary deferrals** in excess of \$16,500, so this test passes.

Correcting the Problem

If **participants** fail this test, an adjustment is typically required, resulting in a refund of the **excess deferrals**, plus interest, if any, reported as taxable income.

Annual Additions Test (415 Limit)

Under this test, a **participant's** annual addition is limited to \$49,000 (as adjusted by the **IRS**) or 100% of gross compensation in 2009, whichever is less. For participants who are at least age 50, the limit can be as high as \$54,500 if the plan allows catch-up contributions.

*Generally, annual additions include **salary deferrals, matching contributions, profit sharing contributions, forfeiture allocations, and any QNECs or QMACs.***

Annual Additions Test in Action

According to the Table of Facts, the only contributions made to the plan during the plan year were **salary deferrals**. Since no **participant** received more than \$49,000 or 100% of **compensation**, this test passes.

Correcting the Problem

If **participants** fail this test, they may receive refunds on the excess amounts contributed to the plan. Usually, the deferral amounts are returned first before a **participant** forfeits any other type of contribution.

Top-Heavy Test (416)

A top-heavy plan is a retirement plan that primarily benefits a company's **key employees**.

A plan is considered top heavy if the total account balances of all **key employees** are more than 60% of the total of the account balances for all **participants** in the plan.

Generally, the account balances as of the last day of the preceding plan year determine the top-heavy status for the following plan year. Example: A plan's top-heavy status for 2009 is determined based upon the account balances as of the end of the previous plan year (e.g., as of 12/31/2008 where the plan year is based upon the calendar year). However, for a new plan, the last day of the *first* plan year determines the top-heavy status for *both* the first and second plan years.

Using the same example as above, assume the plan was initially effective in 2008. The plan's 2008 and 2009 top-heavy status are determined as of 12/31/2008.

A special rule also applies when determining the account balances as of the end of the plan's first year: any contributions made after the end of the first year (e.g., after 12/31/2008) but which are allocated for that year (e.g., allocated as of 12/31/2008) are added-back to determine the participants' account balances as of 12/31/2008. Example: Same facts as before, except assume a \$10,000 profit sharing contribution was made for the first plan year ended 12/31/2008. Further assume that the \$10,000 was not actually deposited until 02/2009. Even though the \$10,000 was not deposited by 12/31/2008, because 2008 was the plan's first year and because the \$10,000 was allocated for the 2008 plan year, the \$10,000 is added-back to determine the participants' balances as of 12/31/2008, and is used in determining the plan's top-heavy status for both 2008 and 2009.

Top-heavy plans are required to meet special vesting and minimum contribution requirements. Transamerica or your TPA will help you determine whether your plan is top heavy and the steps to take to comply with the top-heavy rules.

Top-Heavy Test in Action

According to the Table of Facts, the two **HCEs** are also the only two **key employees**. Although the definition of an **HCE** and a **key employee** are not the same, many times the same employees will be both **HCEs** and **key employees**. For purposes of the top-heavy test, assume at the beginning of the year, the two **key employees'** account balances equaled \$25,000. Furthermore, assume that the total account balances for all **participants** (including former employees) at the beginning of the year equaled \$100,000. Based upon this information, the plan is not top heavy because the **key employees'** balances (\$25,000) do not exceed more than 60% of \$100,000, the total of the balances under the plan.

Correcting the Problem

If your plan is top heavy, the employer might be required to make a minimum contribution for each **non-key employee**. Transamerica will notify you of the amount, if any, required to satisfy the minimum contribution requirement (which, as a general rule, is 3% of each eligible non-key employee's **compensation**). In addition to a minimum contribution, the plan's **vesting schedule** for profit sharing contributions needs to be within **IRS** guidelines. When Transamerica or your TPA reviews and/or helps prepare your plan documents, we make certain that your plan documents provide a top-heavy vesting schedule, should the need ever arise. Beginning in the 2007 plan year, most plans will already have a vesting schedule meeting the top-heavy requirements due to compliance with the Pension Protection Act of 2006 (PPA).

Safe Harbor—The Nondiscrimination Testing Alternative

While 401(k) plans, including those allowing Roth 401(k) contributions, must pass the various nondiscrimination tests each year, safe harbor 401(k) plans are deemed to pass some of the tests.

A safe harbor plan is deemed to pass the following tests:

- The actual contribution percentage (ACP) and actual deferral percentage (ADP) tests.
- The top-heavy requirements, under certain circumstances.

In a typical safe harbor 401(k) plan, the employer has four safe harbor options. The employer may choose to make the safe harbor contributions on behalf of the **HCEs**, and not only for the **NHCEs**.

Two types of safe harbor contributions are immediately 100% vested:

- Match each **NHCE's salary deferrals**, dollar-for-dollar, up to 3% of the **NHCE's compensation** and a 50% match on **salary deferrals** above 3% but not more than 5% of compensation (variations of this matching contribution formula are available).
- A nonelective contribution to the **NHCEs** of at least 3% of compensation.

Two types of safe harbor contributions are immediately 100% vested after two years (or, if the plan sponsor chooses, these contributions may be immediately 100% vested). These safe harbor contributions are only allowed for a plan with a **Qualified Automatic Contribution Arrangement**.

- Match each **NHCE's salary deferrals** dollar-for-dollar of the first 1% of **NHCE's compensation**, and a 50% match of the next 5% of compensation (maximum 3.5% of compensation).
- A nonelective contribution to the **NHCEs** of at least 3% of compensation.

Not all companies are good candidates for a safe harbor plan, so compare the advantages and disadvantages. Factors such as employee appreciation, the amount of time you save skipping the nondiscrimination tests, the ability of the **HCEs** to fully benefit under the plan, and the expense of making 100% vested safe harbor contributions should be considered.

Timing is Everything

Your qualified retirement plan must be tested annually. Many employers like to conduct interim testing to make sure there are no surprises at the end of the year. Situations where adding safe harbor contributions should be considered include:

- If your company has a high rate of employee turnover, is involved in a merger or spin-off, or experiences any other kind of major shift in the employee population during the year.
- Your plan has failed contribution-related testing in the past.

Transamerica Retirement Services Support You Can Count On

Because your company and your retirement plan can change every year, Transamerica and your TPA can help you determine which tests are required for your plan. From comprehensive plan design and quality investments, to effective and award-winning* employee education, Transamerica and your TPA provide the tools and expertise to help you achieve the results you want.

For more information about 401(k) plan testing and the wide range of our resources, contact your plan administrator or your TPA.

*Transamerica Retirement Services' communication materials have received awards from various organizations, including the Awards for Publications Excellence (APEX) in 2007-2008; Communicator Awards 2005-2007; DALBAR, Inc. in 2005-2007; Hermes Creative Award in 2007 and 2008; and the Insurance and Financial Communicators Association ("IFCA") in 2008. For more information please refer to the Web site www.TA-Retirement.com.

GLOSSARY

401(k) Plan

This is a type of **qualified retirement plan**. This type of plan includes **salary deferrals** made by employees. This plan can also include **matching employer contributions** and/or **profit sharing contributions**, but such contributions are not required.

Adopting Employer

The business entity whose payroll and perhaps other services (such as staffing, human resource, and employee benefits) are provided by a staffing firm, and where the staffing firm (or its affiliate) provides a multiple employer plan.

Adoption Agreement

The document a plan sponsor signs to establish a plan. The adoption agreement reflects choices of certain plan provisions, including eligibility requirements, the types and amounts of contributions allowed, the allocation method for employer contributions, the vesting schedule applicable to employer contributions, and distribution options.

Affiliated Service Group

This is an IRC-defined term that references more than one employer (a group of employers) whose ownership interests and affiliations with each other are so closely aligned that the **IRS** treats the group for various purposes, including **qualified retirement plans**, as one employer. An example of an affiliated service group is where Employer A owns 20% of Employer B, both employers provide services as their primary source of income, and Employer B's only "customer" is Employer A (e.g., Employer A has no IT department, and Employer B provides only IT support services, and the only client of Employer B is Employer A). As with a **controlled group**, the determination of whether or not an affiliated service group exists can be complicated, and should be done with the assistance of tax and/or legal counsel.

Amendment

Any changes to a plan document (such as changes to the **eligibility requirements**) are made by a written, signed document, referred to as an amendment.

Automatic Enrollment

Enrolling all eligible employees in a plan and beginning **salary deferrals** at a predetermined deferral rate without requiring the employees to submit a request to participate. The plan specifies how these automatic deferrals will be invested. Employees who do not want to make **salary deferrals** to the plan must actively file a request to be excluded from the plan. **Participants** can generally change the amount of pay that is deferred and how it is invested. Instead of applying **automatic enrollment** to all employees, the **plan sponsor** may choose to apply **automatic enrollment** to only certain employees, such as those newly eligible for the plan after the date **automatic enrollment** is added to the plan.

Catch-up Contributions

These are **salary deferrals** that may be made in addition to the normal limitation on **salary deferrals**, provided the plan allows catch-up contributions (e.g., for 2009, a **participant** may normally make salary deferrals up to \$16,500, and if the plan allows catch-up contributions, up to an additional \$5,500 pre-tax contributions may be made). Only **participants** who are at least age 50 or who will be age 50 during the year may make catch-up contributions. For 2009, the catch-up contribution limit is \$5,500 (again, this is only if the plan allows catch-up contributions).

Compensation

The employer selects what type(s) of compensation will be included for purposes of the plan (e.g., all compensation; all compensation except for bonuses; all compensation except for compensation earned prior to becoming a **participant** in the plan). In the case of an outsourcing organization handling the plan, it would be the outsourcing organization that chooses the definition of compensation, not the adopting employer.

Compensation Test

This test compares the average percentage of the **HCEs'** covered compensation to the average percentage of the **NHCEs'** covered compensation. Covered compensation is the gross compensation less the compensation excluded by your plan. The percentage of the **HCEs** (as defined in plan) can exceed the percentage of the **NHCEs** only within a certain limit. Note that it's always permissible for the percentage of the **NHCEs** to exceed the percentage of **HCEs**. If a plan fails this test, some or all of the excluded compensation must be added back. Adding back the excluded compensation might require the employer to fund additional contributions.

Compliance Tests

Internal Revenue Service (**IRS**)-mandated tests that compare contribution levels and actual amounts made by different classifications of plan participants. The most common tests that 401(k) plans must pass each year are the minimum coverage test, compensation test, actual deferral percentage (ADP) test, actual contribution percentage (ACP) test, deferral limit test, annual additions limit test and the top-heavy test.

Controlled Group

This is an IRC-defined term that references more than one employer (a group of employers) whose ownership interests are so closely aligned that the **IRS** treats the group for various purposes, including **qualified retirement plans**, as one employer. An example of a controlled group is where Employer A owns 100% of Employer B. Employer B is said to be under the control of Employer A, and thus, the two employers comprise a controlled group. The determination of whether or not a controlled group exists can be complicated, and should be done with the assistance of tax and/or legal counsel.

DOL

The Department of Labor.

Eligibility Requirements

The employer chooses requirements an employee must meet to benefit under the employer's plan, within IRC permissible guidelines. Typical **eligibility requirements** are age requirements (such as an employee must be at least age 21) and service requirements (such as an employee must have earned a year of service, which is typically a 12-month consecutive period during which the employee worked at least 1,000 hours). An employer may choose only an age requirement; only a service requirement; or may choose no requirements at all.

Entry Date

The employer chooses which date(s) an employee who has met the eligibility requirements will become a **participant** (known as the date the employee “enters the plan”). Typical entry dates are quarterly (e.g., each January 1, April 1, July 1, and October 1), monthly (e.g., the first day of each month), or even daily! Entering the plan is automatic—an employee doesn't have to do anything. However, if the plan is a **401(k) plan**, the employee has to complete a **salary reduction agreement** of some sort in order to start making **salary deferrals** to the plan.

ERISA

Employee Retirement Income Security Act of 1974, legislation designed to protect the rights of the plan **participants** and beneficiaries.

Excess Contributions

Contributions for **HCEs** in excess of the amount allowed under nondiscrimination rules. These **salary deferrals** must be refunded due to a failed ADP test.

Excess Deferrals

These are **salary deferrals** that exceed the IRC's annual limit. For example, the IRC limit on **salary deferrals** for 2009 is \$16,500. If a **participant** makes salary deferrals in the amount of \$17,000, the amount of excess deferrals equals \$500, and must be refunded (plus any gains) and taxed as ordinary income.

Fiduciary

Generally, the person who provides investment advice to a company's qualified retirement plan for a fee, and/or has discretionary control or authority over the administration of the plan, and/or has authority or control over the assets of the plan.

Form 5500

The Form 5500 is required by the IRS and Department of Labor annually. The Form 5500 provides statistical information about the plan and plan sponsors, reports financial information about the plan, and demonstrates compliance with coverage rules.

Highly Compensated Employee (HCE)

The IRC defines a highly compensated employee as an individual who owned more than 5% of the interest in the business at any time during the current or preceding year (and lineal relative such as the parent, spouse, child, or grandparent of that person, with some restrictions). Additionally, a highly compensated employee is classified as someone who for the previous year received compensation from the employer of more than \$105,000 (indexed). Alternately, the **plan sponsor** may choose in the **adoption agreement** to classify a highly compensated employee as an employee who for the previous year received compensation from the employer of more than \$105,000 (indexed) and who was also in the top 20% of employees ranked by compensation in that year.

IRC

The Internal Revenue Code. Collection of tax rules of the federal government. Also referred to as Title 26 of the United States Code.

IRS

The Internal Revenue Service.

Key Employees

A participant who, at any time during the plan year containing the determination date is:

- A more than 5% owner of the employer (family attribution rules apply);
- A more than 1% owner of the employer with annual compensation greater than \$150,000 (family attribution rules apply); or
- An officer with annual compensation greater than \$150,000 during 2008 for an existing plan. If 2009 is the plan's first year, then a key employee is an officer with annual compensation greater than \$160,000 during 2009.

Normally, the determination date is the last day of the previous plan year. The family attribution rules include an owner's spouse, parent, child, or grandparent.

Matching Contributions

These are contributions made by the employer for employees who have made **salary deferrals**. These contributions may be discretionary, meaning the employer is never obligated to make a contribution, or these contributions may be mandatory, meaning the employer is obligated to make a contribution. In addition, whether discretionary or mandatory, the employer generally chooses a formula for the allocation of the matching contributions, such as matching 50% of the first 3% of **salary deferrals** an employee makes.

Non-Highly Compensated Employee (NHCE)

All employees other than highly compensated employees (**HCEs**). **NHCEs** are employees who own less than 5% of the employer; are not a lineal family member of a more than 5% owner of their company; do not earn more than \$105,000 during the prior plan year (indexed); or in some cases, earn more than \$105,000 during the prior plan year (indexed), but are not in the top 20% of employees ranked in order of compensation.

Nondiscrimination Testing

Qualified retirement plans must meet certain tests each year, proving that the plan does not benefit the **highly compensated employees** and/or the **key employees** more than the **non-highly compensated employees** and/or **non-key employees** (within limits).

Non-Elective Contribution

Employer contributions other than matching contributions.

Non-Key Employees

Non-key employees are employees other than **key employees**. Generally, non-key employees are those with no ownership interest in the employer; non-officers of the employer; officers of the employer but who receive compensation less than \$160,000; and employees who are not lineal family members of a person who, 1) owns more than 1% of the employer, and 2) who received compensation greater than \$150,000.

Participant

An employee who has met the **eligibility requirements** of the plan, and in addition, who is employed on the plan's **entry date** (regardless of whether the individual elects to make salary deferrals). Once entered in the plan, an employee remains a participant until his/her entire vested benefit is distributed to him/her, and he/she is no longer employed.

Plan Document

A requirement for a **qualified retirement plan** is to have a written document, detailing the specifics of the plan (such as **eligibility requirements**). The written document, plus all applicable other documents, if any, are collectively referred to as the plan document.

Plan Sponsor

The individual or company responsible for sponsoring the retirement plan, (such as a staffing firm that sponsors a multiple employer plan for adoption by an **adopting employer** to benefit the **adopting employer's** employees).

Plan Year

This is the tax year of the plan, which is normally a 12-month consecutive period. Most plans operate on the calendar year, where the plan year is the same as the calendar year (i.e., from January 1 through December 31).

Profit Sharing Contributions

These contributions are discretionary contributions made by the employer for all eligible employees. Eligible employees are those who have met the plan's **eligibility requirements**, and if the employer chooses, who must meet additional annual requirements (such as being employed on the last day of the plan year to receive a profit sharing contribution, if made that year).

Qualified Automatic Contribution Arrangement

The **automatic enrollment** of employees who do not affirmatively elect to make **salary deferrals**. The deferral rates for employees who are automatically enrolled must be at least 3% of **compensation** the first year, 4% the second year, 5% the third year, and 6% the fourth year. In no year may the deferral rate exceed 10% of **compensation**. Deferrals made under a **Qualified Automatic Contribution Arrangement** must be invested in a qualified default investment option meeting **DOL** guidelines.

Qualified Matching Contributions (QMACs)

These are additional employer matching contributions that are 100% vested immediately. Generally, an employer makes these contributions to help pass an **ADP test** that initially failed. By using **QMACs** to pass an **ADP test**, **HCEs** may not be required to receive refunds of **excess contributions**.

Qualified Non-Elective Contributions (QNECs)

These are additional employer contributions that are 100% vested immediately. Generally, an employer makes these contributions to help pass an **ADP/ACP test** that initially failed. By using a **QNEC** to pass an **ADP test**, the employer may avoid **HCEs** receiving refunds of **excess contributions**. Using a **QNEC** to pass an **ACP test** allows the employer to avoid refunding or forfeiting **matching contributions** made to **HCEs**.

Qualified Retirement Plan

The **IRS** gives employers and employees certain tax breaks for benefits that accumulate under a qualified retirement plan. To be qualified, the plan must meet a number of **IRS** and **DOL** requirements, including passing **nondiscrimination testing**. Some of the tax breaks for employers include a current tax deduction for contributions made to the plan. For employees, some of the tax breaks are the deferred taxation of retirement benefits, and earnings, to the date the benefits and earnings are withdrawn from the plan (versus being taxed at the time the contributions are made to the retirement plan and when earnings are realized).

Roth 401(k) Contributions

These are elective deferrals to a **401(k) plan** that have been designated irrevocably by an employee as not excludable from the employee's gross income and to be deposited into a designated Roth account under the plan. Thus, the contributions are treated by the employer as includible in the employee's gross income at the time the employee would have received the amount in cash if the employee had not made the election (hence subject to all applicable wage withholding requirements).

Salary Deferral

This is the compensation an employee elects to be paid directly to a **401(k) plan** from his/her salary on a pre-tax basis, rather than being included in his/her net paycheck. If the plan allows Roth 401(k) contributions, an employee may make salary deferrals on an after-tax basis.

Salary Reduction Agreement

An agreement between the employee and the employer, generally signed and dated by the employee, whereby the employee agrees to have the employer make **salary deferrals** on the employee's behalf to a **401(k) plan**. This may be done online as well, if that option is included in the **participant's** plan.

Vesting

The portion of a **participant's** account balance under the plan that he or she is entitled to under the plan's rules. Depending on the provisions of the plan, employees usually become "vested" over a period of years.

Vesting Schedule

This is a schedule showing how much of his/her account balance a participant will receive should he/she leave employment. **Salary deferrals** and safe harbor contributions are always 100% vested immediately. **Matching contributions** and **profit sharing contributions** are generally subject to a vesting schedule. A typical vesting schedule for matching contributions and/or profit sharing contributions is for a participant to have a zero vested percentage until earning 2 **years of service**, at which point he/she is 20% vested in his/her account balance; and for each year of service earned thereafter, to have an additional 20% vesting each year, with 100% vesting after earning 6 years of service.

Year of Service

A year of service is generally defined as a 12-consecutive month period during which an employee works at least 1,000 hours.

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