# Compensation Ratio Test

## Test to Ensure a Plan Does Not Discriminate in Favor of Highly Compensated Employees

Some employers choose to exclude certain forms of compensation (i.e., bonus, commission, overtime, etc.) for purposes of allocating contributions. Plans that choose this option are required to pass the Compensation Ratio Test each year.

### Why is this Test Required?

401(k) Plans were created by Congress as a system to help U.S. workers save for retirement. Special tax incentives are provided to encourage employers to adopt plans, promote savings, and make contributions broadly available to workers. The Compensation Ratio Test is one method of ensuring that employers promote savings among all workers and not just among owners and key executives. Otherwise, employers might be able to design compensation systems within their company aimed at maximizing contributions for business owners and key executives and minimizing contributions for other workers.

### How is the Test Calculated?

This test groups eligible participants into two categories – (1) Highly Compensated Employees (HCEs), and (2) Non-Highly Compensated Employees (NHCEs). The test then requires that a Compensation Ratio be calculated for each participant in the plan. This ratio is calculated by dividing compensation as defined in the plan by compensation as defined under a statutory safe harbor definition. The test then requires that the average ratio of each group be determined. The average ratio for the HCEs may not exceed the average of the NHCEs by more than a de minimus amount.

What constitutes a de minimus amount has not been specifically defined in regulations. Some commentators have quoted IRS personnel as informally indicating they will use a 3% or less difference as a de minimus standard, but they emphasize this is a guide only and not a safe harbor.

***HCE Definition*** – An HCE is defined by Internal Revenue Service Regulations. In general, an employee is considered an HCE if they (1) own 5% or more of the company or (2) earned more than $120,000[1] in the preceding year. There are other parts of this definition that might cause an employee to be considered an HCE, including certain family relationships with an owner and other complex factors.

### Methods for Correcting a Failed Test

If a Plan fails this test but can demonstrate a passing Average Benefits Test then the annual requirement has been fulfilled. If the Plan is unable to demonstrate both a passing Compensation Ratio Test and a passing Average Benefits Test, then the plan must be amended to change the definition of compensation to something that will result in a passing Compensation Ratio Test.

### Strategies to Avoid Failing

To completely eliminate the need to perform the annual Compensation Ratio Test, a plan could amend their document and adopt a statutory safe harbor definition of compensation and include bonus, commission, overtime, and other forms of pay in the plan's definition of Compensation.

It may also be possible to adjust the definition of compensation in a way that still excludes some forms of compensation but just to a lesser degree.

Please contact JULY at 888.333.5859 for more information.

[1] The HCE Compensation Limit is indexed annually for inflation. The amount for 2018 is $120,000.