Retirement/401K Plans and Secure Act

By: Anne Kelly, CAHIP-OC Sponsorship Chair & Professional Development Committee Member

The 401(k) mandate in California and the SECURE Act 2.0, as well as 401(k) testing and safe harbor rules, are critical topics for retirement plan sponsors and employees.

Below is a detailed breakdown:

California 401(k) Mandate

- **CalSavers**: California has implemented a retirement savings mandate known as **CalSavers**. Employers with five or more employees are required to either offer their own retirement plan (like a 401(k)) or enroll in CalSavers, a state-sponsored retirement savings program.

Deadlines: Companies with 5 or more employees must comply with CalSavers as of **June 30, 2022. This goes down to 1 employee December 2025.**

Non-compliant employers may face penalties, up to $750 per eligible employee after repeated failures to enroll employees.

SECURE Act 2.0 (2024-2025 Rules)

The **SECURE Act 2.0**, passed in December 2022, continues to reshape retirement plans. Here are the key provisions for 2024-2025:

Key Changes for 2024:

- **Automatic Enrollment**: Beginning in 2024, most new 401(k) and 403(b) plans must automatically enroll eligible employees with a contribution rate of at least 3%, increasing annually by 1% up to at least 10%, but no more than 15%. Employees can opt out.

- **Catch-up Contributions**: Employees aged 50 or older can make catch-up contributions of an additional $7,500 (for 2023; subject to future adjustments). Starting in 2024, if the employee earns more than $145,000, catch-up contributions must be made as **Roth contributions** (after-tax).

Matching Roth Contributions: Employers can now offer **matching contributions to Roth accounts**, which were previously restricted to pre-tax contributions only.

Key Changes for 2025:

- **Mandatory Catch-up Increase for Ages 60-63**: Employees between the ages of 60-63 can make larger catch-up contributions—up to the greater of $10,000 or 150% of the standard catch-up limit for 2025.

Part-Time Employees: As of 2025, part-time employees who work at least 500 hours per year for two consecutive years will become eligible to participate in 401(k) plans.

401(k) Top-Heavy Testing

A **top-heavy plan** is one in which key employees (owners and highly compensated employees) hold 60% or more of the plan's assets.

Owners with more than 5% and **officers earning over $215,000** are considered key employees. If key employees hold more than 60% of the total plan assets, the plan is considered **top-heavy**.

If a plan is top-heavy, the company must contribute a minimum of **3%** of compensation for all non-key employees.

- **2024/2025 Testing**: Top-heavy testing is performed annually. If the plan is top-heavy, the employer must meet the contribution requirements, regardless of employees' deferral rates.

- **Correction**: Employers can correct top-heavy status by providing additional contributions or changing the plan design to avoid the top-heavy status, potentially utilizing **safe harbor plans** to bypass these rules.

401(k) Discrimination Testing

Discrimination tests ensure that a 401(k) plan does not disproportionately favor highly compensated employees (HCEs). There are three main tests:

- **Actual Deferral Percentage (ADP)**: Compares the salary deferral percentages of HCEs and non-HCEs.
- **Actual Contribution Percentage (ACP)**: Compares employer matching contributions received by HCEs and non-HCEs.
- **Top-Heavy Test**: As mentioned earlier, tests the concentration of benefits in key employees' accounts.

2024/2025 Testing Rules: Employers must still perform these tests annually unless they adopt a **safe harbor plan** that automatically satisfies ADP and ACP testing.

- **Actual Deferral Percentage (ADP) Test**

The ADP test limits how much highly compensated employees can defer into their 401(k) based on the average deferral percentage of non-highly compensated employees.

ADP Formula: The **average deferral percentage** for HCEs is compared to the **average deferral percentage** for NHCEs. The **maximum contribution rate for HCEs depends on the NHCEs' average contribution rates**.

- The limits for HCEs are:

- If the NHCE average deferral rate is **0% to 2%**, HCEs can defer **up to 2 times** the NHCE rate.

- If the NHCE average deferral rate is **2% to 8%**, HCEs can defer **up to 2% more** than NHCEs.

- If the NHCE average deferral rate is **greater than 8%**, HCEs can defer **up to 1.25 times** the NHCE rate.

2. Actual Contribution Percentage (ACP) Test

The ACP test works similarly to the ADP test but looks at **employer matching contributions** and employee **after-tax contributions**.

ACP Formula: Like the ADP test, the ACP test compares the average percentage of employer matching and after-tax contributions for HCEs against NHCEs.

- The same ratios apply:
- If NHCE average contribution rate is **0% to 2%**, HCEs can receive up to **2 times** the NHCE rate.
- If NHCE average contribution rate is **2% to 8%**, HCEs can receive up to **2% more** than NHCEs.
- If NHCE average contribution rate is **greater than 8%**, HCEs can receive up to **1.25 times** the NHCE rate.

<u>Note: Failing the TOP Heavy test would require your Employer to MATCH 3% for 2 Years until plan came back into compliance. Never put money In as an Owner until you know what the regular employees have in the plan .</u>

A **safe harbor 401(k)** plan is exempt from annual nondiscrimination testing (ADP and ACP tests) if it meets specific contribution requirements. Employers must make **either**:

- **Basic matching contribution**: **<u>100% match of the first 3% of compensation and 50% match on the next 2%. (i.e 4%)</u>**
- **Enhanced matching contribution**: A match more generous than the basic match.
- **Non-elective contribution**: At least 3% of compensation to all eligible employees, regardless of their deferral rate.

Vesting and Safe Harbor Contributions

Safe harbor contributions are **immediately 100% vested**. Employers **cannot apply a vesting schedule to these contributions**, which means employees have immediate ownership of the matching or non-elective contributions made under a safe harbor 401(k) plan.

However, non-safe harbor contributions, such as discretionary profit-sharing or additional employer matches, can still have vesting schedules, such as a **graded vesting** (e.g., 20% per year over 5 years) or **cliff vesting** (100% after 3 years).

In the context of 401(k) plans, **owners** and **highly compensated employees (HCEs)** are important categories when it comes to plan administration, compliance, and testing (e.g., discrimination and top-heavy testing). For 2024 and 2025, here are the key definitions:

Owners (Key Employees)

For purposes of **top-heavy testing**, an **owner** or **key employee** is generally defined as any of the following:

Owners with more than 5% ownership: Any employee who owns more than 5% of the company, directly or indirectly, at any point during the year or the preceding year. This applies to ownership in terms of shares, voting power, or capital interest.

Owners with more than 1% ownership and compensation over $150,000: Any employee who owns more than 1% of the company and earns more than $150,000 in compensation for the year.

Officers: Any officer of the company who had compensation greater than $215,000 for 2023 (indexed for inflation for 2024 and 2025). The limit on the number of officers that can be classified as key employees is the lesser of 50 employees or the greater of 3 employees or 10% of the workforce.

Highly Compensated Employees (HCEs)

An HCE is defined by the IRS for 401(k) purposes as one who meets one of the following criteria:

Ownership Test: An employee who owns more than 5% of the company during the current year or the previous year. This includes both direct and indirect ownership (e.g., family ownership via attribution rules).

Compensation Test: Any employee who earned more than $150,000 in compensation during the previous year (for the 2023 plan year). This threshold is indexed for inflation, so the HCE compensation threshold for the **2024 plan year** is expected to be around $155,000, with an increase to approximately $160,000 for the **2025 plan year** (adjustments pending final IRS guidelines).

Family Attribution Rules

When determining ownership for both **key employees** and **HCEs**, **family attribution rules** apply. These rules attribute ownership from family members to the employee. For example:

- Spouses
- Parents
- Children

This means that if an employee's spouse owns more than 5% of the company, the employee is considered to own that 5% as well, making them a key employee or HCE, even if they don't directly own any shares themselves.

Key Differences and Implications for Testing

Top-Heavy Testing: **Owners with more than 5%** and **officers earning over $215,000** are considered key employees. **If key employees hold more than 60% of the total plan assets, the plan is considered top-heavy**.

Discrimination Testing (ADP/ACP Tests): **HCEs** (who earn over the threshold or own more than 5%) must be compared to non-HCEs to ensure the plan doesn't disproportionately favor the HCE group in contributions or benefits.

Planning Considerations for 2024-2025:

- Employers should closely monitor the **HCE threshold**, as inflation adjustments can impact plan eligibility and testing.

It is important to review ownership structures and compensation to determine whether individuals are classified as **HCEs** or **key employees** for compliance with testing and contribution requirements.

##