



ADP / ACP TESTING

Frequently Asked Questions

WHAT IS THE ADP TEST?

The Actual Deferral Percentage (ADP) test is an annual non-discrimination test that ensures that the salary deferrals in 401(k) plans do not disproportionately benefit Highly Compensated Employees (HCEs) as compared to Non-highly Compensated Employees (NHCEs).

WHAT IS THE ACP TEST?

The Actual Contribution Percentage (ACP) test is an annual non-discrimination test that ensures that the employer matching contributions and/or employee voluntary after tax contributions in 401(k) and 403(b) plans do not disproportionately benefit Highly Compensated Employees (HCEs) as compared to Non-highly Compensated Employees (NHCEs).

HOW ARE THE ADP AND ACP TESTS PERFORMED?

The ADP test compares the average rate of salary deferrals of the HCEs to the average rate of salary deferrals of the NHCEs. The ACP test compares the average rate of employer matching and/or employee voluntary after-tax contributions of the HCEs to that of the NHCEs. The tests pass if the ADP and ACP of the HCEs do not exceed the ADP and ACP of the NHCEs by no more than 1.25 times or 2 percentage points. An illustration of the test is below:

		COMPENSATION	SALARY DEFERRALS	ADP	EMPLOYER MATCH	ACP
HCEs	John	\$275,000	\$18,500	6.73%	\$8,250	3.00%
	Carolyn	\$200,000	\$15,000	7.50%	\$6,000	3.00%
	Steve	\$125,000	\$12,500	10.00%	\$3,750	3.00%
	AVERAGE			HCE ADP 8.08%		HCE ACP 3.00%
NHCEs	Amanda	\$100,000	\$12,000	12.00%	\$3,000	3.00%
	Mike	\$50,000	\$0	0.00%	\$0	0.00%
	Lisa	\$40,000	\$4,000	10.00%	\$1,200	3.00%
	Gary	\$35,000	\$2,400	6.86%	\$1,050	3.00%
	AVERAGE			NHCE ADP 7.22%		NHCE ACP 2.25%
	Max HCE			9.22%		4.25%
	Result			PASS		PASS

WHO IS CONSIDERED A HIGHLY COMPENSATED EMPLOYEE?

A Highly Compensated Employee is an individual who either owns more than 5% of the Company or had compensation in excess of \$120,000 (indexed) in the **prior** Plan Year.

ARE ALL EMPLOYEES INCLUDED IN THE ADP AND ACP TESTS?

All employees who are eligible to make salary deferral contributions are included in the ADP test. Only employees who are eligible to receive a match are included in the ACP test. For example, if your plan requires employment at the end of the year as a condition for receiving a match, then those employees who terminate employment during the year are not included in the ACP test.

ARE ALL CONTRIBUTIONS INCLUDED IN THE ADP AND ACP TESTS?

No. Catch-up contributions are not included in the ADP test.

ARE ROTH DEFERRALS INCLUDED IN THE ADP OR THE ACP TEST?

Yes, Roth deferrals are included in the ADP test and employee voluntary after-tax contributions are included in the ACP test.

WHAT HAPPENS IF A PLAN FAILS EITHER THE ADP AND/OR ACP TEST?

If a Plan fails the ADP and/or ACP test, the failure must be corrected. One correction method is to return excess contributions and earnings to the HCE group. The other option is to allocate additional contributions to the NHCE group.

IF EXCESS CONTRIBUTIONS ARE RETURNED TO THE HCE GROUP, DO THE HCES WITH THE HIGHEST ADP RECEIVE THE REFUNDS?

Not necessarily. Suppose in the earlier example, the maximum HCE ADP is 7.50% instead of 9.22%. The ADP test fails and excess contributions are returned to the HCE group. First, the ADP of the HCEs with the highest percentage is reduced until the test passes. Then the resulting excess contribution, however, is returned to the HCE with the highest dollar deferral:

	COMPENSATION	SALARY DEFERRAL	ORIGINAL ADP	MAXIMUM ADP	EXCESS CONTRIBUTION	RETURN DEFERRALS	NET DEFERRALS
John	\$275,000	\$18,500	6.73%	6.73%	\$0	\$2,162.50	\$16,337.50
Carolyn	\$200,000	\$15,000	7.50%	7.50%	\$0	\$0	\$15,000
Steve	\$125,000	\$12,500	10.00%	8.27%	\$2,162.50	\$0	\$12,500
Average			8.08%	7.50%			

WHEN MUST A FAILED ADP AND/OR ACP TEST BE CORRECTED?

The correction for a failed ADP and/or ACP test must be made within 12 months after the end of the Plan Year of the failure. The correction should be made within 2 ½ months after the end of the Plan Year to avoid a 10% excise tax on returned deferrals.

ARE ALL 401(K) PLANS SUBJECT TO THE ADP AND/OR ACP TESTS?

No. Safe Harbor 401(k) Plans are deemed to automatically satisfy the ADP and ACP tests (employer match only not voluntary after-tax). A Safe Harbor 401(k) Plan allocates guaranteed contributions to NHCEs and sometimes HCEs. The guaranteed contribution can be in the form of a Non-elective Employer Contribution or an Employer Matching Contribution. Furthermore, the Safe Harbor contributions are fully vested and cannot be subject to allocation conditions.