

ADP and ACP TESTING

To maintain tax-qualified status, 401(k) plans must undergo nondiscrimination testing each year to ensure Highly Compensated Employees (HCEs) are not benefiting significantly more than Non-Highly Compensated Employees (NHCEs). Actual deferral percentage (ADP) and actual contribution percentage (ACP) are two of these tests. ADP testing measures employee deferrals (pre-tax and Roth), while ACP testing measures employer matching and after-tax employee contributions.

How are the tests performed? Let's take a look

STEP 1: Determine which participants are eligible. For the ADP test, "eligible" means those who could defer based on the plan's eligibility provisions. For the ACP test, "eligible" means those who could receive a match if they could have chosen to defer.

STEP 2: Determine which employees comprise the HCE group and NHCE group. **What is an HCE?**

- A more than 5% owner in the previous or current year
- Any employee whose gross wages in the prior year exceed a certain threshold (\$120,000 for 2017)
- If the plan document applies a special testing election, the non-owner group may be limited to only the top-paid 20% of certain eligible employees.

STEP 3: Determine the testing compensation, deferrals (ADP), and contributions (ACP) for the testing year.

Note: The contribution amounts for the NHCE group may be based on prior year or current year data; the plan will specify. HCE calculations always use current year data. Also, catch-up contributions for participants reaching age 50 are not included.

STEP 4: Calculate the averages for the HCE and NHCE groups and compare.

If NHCE's ADP % is: **Then HCE's maximum allowable ADP% is:**

0-2%	2 times more
2-8%	2% more
Over 8%	1.25 times more

ADP Example

Employee	Compensation	Deferral	ADP Ratio
HCE	\$250,000	\$17,500	7%
HCE	\$150,000	\$16,500	11%
HCE ADP: (7+11)/2 = 9%			
NHCE	\$70,000	\$8,400	12%
NHCE	\$65,000	\$5,850	9%
NHCE	\$55,000	\$0	0%
NHCE	\$40,000	\$1,200	3%
NHCE ADP: (9+3+0+12)/4 = 6%			



Since the NHCE ADP ratio is 6%, the HCE ADP ratio is limited to 8% (6% + 2%). This ADP test fails because the 9% HCE ADP ratio exceeds the 8% limit.

Correcting the ADP test

Corrective action must be taken by raising the NHCE percentages, lowering the HCE percentages, or a combination of both.

Raising the NHCE percentage can be done by making a qualified nonelective contribution (QNEC), which is 100% vested and not available for distribution until participants reach age 59½. Lowering the HCE percentage can be done by making a taxable refund of excess deferral contributions to HCEs.

Thus, in this example, the employer could make a QNEC to the NHCEs to bring their ADP up to 7% or they could refund excess contributions to the HCEs to bring their ADP down to 8% to make the test pass.

ACP Example

Employee	Compensation	Employer Match	ACP Ratio
HCE	\$250,000	\$10,000	4%
HCE	\$150,000	\$6,000	4%
HCE ACP: (4+4)/2 = 4%			
NHCE	\$70,000	\$2,800	4%
NHCE	\$65,000	\$2,600	4%
NHCE	\$55,000	\$0	0%
NHCE	\$40,000	\$0	0%
NHCE ACP: (4+4+0+0)/4 = 2%			

Since the NHCE ratio is 2%, the HCE ratio can go up to 2% over this, so the test passes.

Correcting the ACP Test

If the ACP test fails, the correction is very similar to ADP test corrections: action must be taken by raising the NHCE percentages, lowering the HCE percentages, or a combination of both. The HCEs can be refunded the vested excess match or qualified matching contributions (QMACs) can be made to NHCEs. QMACs are matching contributions that are 100% vested and cannot be distributed until participants reach age 59½.

Preparing for the Tests or Safe Harbor

Goldleaf Partners can help employers prepare for these tests or discuss options for avoiding them with a Safe Harbor plan. By adopting safe harbor provisions before the first day of the plan year, along with timely notices, a plan can avoid both the ADP and the ACP tests.

Looking for more information on Safe Harbor Plans? Check out our additional resources:

[Safe Harbor FAQ](#)

[Safe Harbor Overview Video](#)

[Safe Harbor Contribution Requirements Video](#)