ADP and ACP TESTING

Understanding these tests for 401(k) plans

The Actual Deferral Percentage (ADP) test must be passed every year for 401(k) plans to retain their tax-qualified status.
Note: If plan elects safe harbor status, this test is not required.

Performing the test

Participants are divided into:

- Highly-Compensated Employees (HCEs)
- Non-Highly Compensated Employees (NHCEs)

- Percentage of salary contributed is calculated per participant
- Percentages are averaged for each group
- Average percentage for HCEs may be greater than NHCEs employees, but only by limited amount

Who are Highly Compensated Employees?

Highly Compensated Employees (HCEs) own more than 5% of the company or earned over a statutory dollar limit, indexed for inflation, in the immediately preceding plan year ($150,000 in 2023 for testing in 2024).

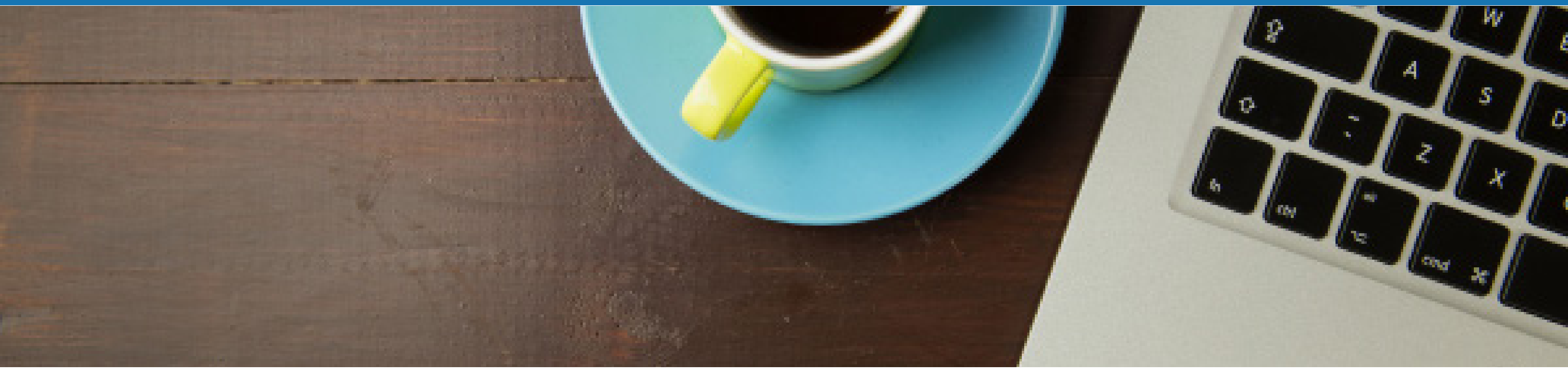
How can the ADP test be corrected?

If the difference in the above calculation is too great, percentages must be adjusted until the test is passed. The most common way to do this is by refunding contributions made by HCEs. Another method is to provide for corrective contributions to NHCEs, known as qualified non-elective contributions, or QNECs. These can be made to increase the average deferral percentages until they pass the ADP test.

The SECURE Act allows for an additional option where employers can retroactively adopt a 4% safe harbor non-elective contribution provision. This allows plan sponsors to pass the ADP and ACP tests automatically if they fund a 4% safe harbor non-elective employer contribution for all participants, regardless of employee deferrals. The 4% safe harbor non-elective employer contribution can be reduced to 3% for future plan years.

How are the refunded contributions determined?

The calculation of refunds begins with the HCE with the highest contribution. His or her contribution is lowered to the next highest HCE's contribution level. Then, both contributions are reduced together until reaching the next highest HCE's contribution level, and so on, until the total dollar amount of refunds returned reaches the amount necessary. It is important to note that the employer cannot determine who gets a contribution refunded; this is determined by treasury regulations.



What are the tax effects of the contribution refund?

By refunding amounts to HCEs, their average deferral amount is reduced, which allows the test to be considered passing. HCEs did not pay taxes on the amount they deferred in the year of deferral, so they will pay taxes on any excess contributions that are refunded to them. This is taxed in the year of the refund. Earnings paid out are also taxed in the year of the refund.

Refunds are generally due to be paid within 2.5 months of the end of the plan year being tested. However, plans with an Eligible Automatic Contribution Arrangement have 6 months after the end of the plan year to process refunds. If the deadline is missed, the employer is faced with a 10% excise tax on the amount of the late refunds. If the test is still not corrected within 12 months of the end of the plan year, the plan has a qualification failure that must be corrected to avoid disqualification.

What is the ACP test?

The Actual Contribution Percentage (ACP) test is required for 401(k) plans that have matching contributions or after-tax voluntary employee contributions. To maintain their tax-qualified status, these plans must pass the ACP test every year, unless the employer elects a safe harbor plan. Matching contributions and voluntary employee contributions are tested in the same manner as 401(k) deferrals in the ADP test. All participants eligible to receive a matching contribution, or make a voluntary after-tax contribution, are included in the test.

What methods are available to correct a failed ACP test?

A failed ACP test is corrected using one of these methods (similar to ADP test corrections):

- Excess matching or voluntary employee contributions may be refunded to the HCEs
- An employer may make a QMAC (Qualified Matching Contribution) to the NHCEs
- An employer may add a retroactive 4% safe harbor non-elective employer contribution

Refund taxation and excise taxation depend on when the refunds are paid, just as with refunds for 401(k) deferrals. The ACP test must also be corrected within 12 months following the end of the plan year.