EGPS
ECONOMIC GROUP
PENSION SERVICES

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?

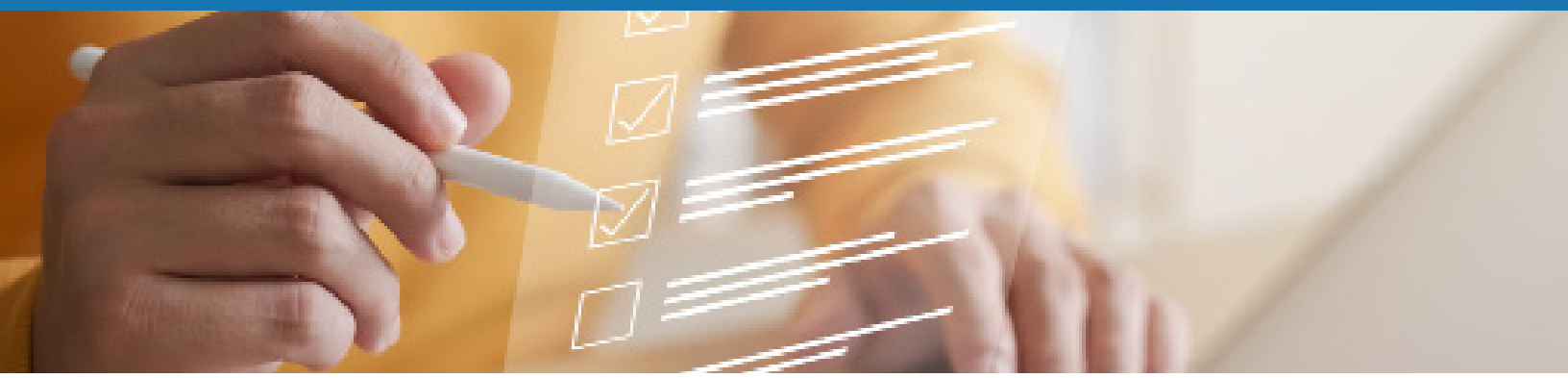
Highly Compensated Employees (HCEs) are individuals who either own more than 5% of the company or earned above the IRS compensation threshold in the prior year used for testing. For the 2026 testing year, the compensation threshold remains $160,000 based on 2025 earnings.

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 involves increasing plan contributions to NHCEs, known as "fail-safe" contributions. These can be made to increase the average deferral percentages until they pass the ADP test. This type of contribution must be allocated in the plan document under "Qualified Non-Elective Contributions" (QNEC).

How are the refunded contributions determined?

Refund amounts are determined by established IRS rules. 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, as deemed by the IRS. It is important to note that the employer cannot determine who gets a contribution refunded; this is determined by the IRS.



What are the tax effects of the contribution refund?

The refund's intended effect is to restore each participant to the financial position they would have been in had the contribution amounts passed the test in the first place. A contribution refund is not an IRS penalty; it is merely an adjustment to the affected employees' plan contributions. This adjustment preserves the tax-qualified status of the plan and the tax deferral of contributions and earnings that remain in the plan.

The refund is taxable in the year distributed, and it must be distributed within 12 months of year-end. If the refunds do not get distributed within 2½ months after the plan year-end, the excess contributions are subject to a 10% excise tax assessed on the plan sponsor. For Eligible Automatic Contribution Arrangements (EACA), the excise tax is due if the refunds don't get paid within six months after the plan year-end.

What happens if the ADP test is not corrected?

If the ADP test is not corrected by either timely refunding excess contributions or making a QNEC contribution, the plan will be disqualified. No tax deductions will be allowed for contributions made to the plan, earnings on the plan investments will be taxed, and distributions from the plan will not be eligible for rollover.

What is the ACP test?

The Actual Contribution Percentage (ACP) test is required for 401(k) plans that have match 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. Match contributions and voluntary employee contributions are tested in the same manner as 401(k) deferrals in the ADP test. Eligible participants to receive a match contribution or make a voluntary employee 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 match or voluntary employee contributions may be refunded to the HCEs
- A employer may make a QMAC (Qualified Match Contribution) to the NHCEs

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.