

ADP and ACP Testing



The ADP and ACP tests prove that a plan is not discriminating in favor of highly compensated employees

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The Internal Revenue Service (IRS) requires all 401(k) plans to be tested annually. The testing fulfills several key purposes. A couple of such tests are the Actual Deferral Percentage Test (ADP) and the Actual Contribution Percentage Test (ACP). The purpose of these tests is to ensure that the plan is operating in a non-discriminatory manner.

The ADP test compares the 401(k) deferrals of the Highly Compensated Employees (generally, those employees who are more than 5% owners or those making more than \$110,000) to the 401(k) deferrals of the Non-Highly Compensated Employees. The ACP test is similar, but compares the amount of the matching contributions allocated to each group. ADP and ACP tests can be performed on a current or prior year basis.

If an ADP or ACP test fails, there are a couple of ways to correct the test. One option is to distribute the amounts that are causing the test to fail to the Highly Compensated Employees. Another option would be to allocate a qualified contribution to the Non-Highly Compensated Employees in order to increase their average percentage. Other options may include adopting a plan with certain required contributions (i.e. a safe harbor plan) that allows a free pass on this testing.



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Understanding ADP and ACP Testing

The ADP test will compare the average deferral percentages of the Highly Compensated Employees (HCEs) to those of the Non-Highly Compensated Employees (NHCEs). The ACP test compares the matching contributions allocated to each group. To determine individual percentages, each participant's deferral or match is divided by their compensation (for example, a participant with \$100,000 in compensation and \$10,000 in deferrals would have a 10% deferral percentage). The individual percentages for each group of employees (HCE and NHCE) are totaled and then divided by the number of participants in that group. The HCE average percentage must be within a certain level when compared to the NHCE average percentage for the test to pass.

| NHCE percentage | HCE percentage |
|------------------------|--|
| Up to 2% | Cannot exceed 1.25 times the NHCE percentage |
| Between 2% - 8% | Cannot exceed 2 plus the NHCE percentage |
| Over 8% | Cannot exceed 2 times the NHCE percentage |

Generally, the test must be performed and, if necessary, corrected before the end of the next plan year. However, it is desirable to complete the testing within the 2 1/2 month period following the end of the plan year. Corrective distributions issued to HCEs after the 2 1/2 month deadline are subject to 15% excise tax—payable by the plan sponsor.

As an alternative to HCE distributions, the plan sponsor may also correct a failed ADP/ACP test by making an additional contribution called a QNEC (Qualified Non-Elective Contribution) or a QMAC (Qualified Matching Contribution). A QNEC is allocated to NHCEs as a kind of extra deferral to increase their average percentage to the point that the ADP test passes. This contribution must be 100% vested and subject to the same withdrawal requirements as 401(k) deferrals. A QMAC is given to NHCEs to help pass the ACP test as an extra matching contribution and must have the same restrictions and 100% vesting as the QNEC.

There are many testing and correction methods available for ADP/ACP Testing. If you are concerned about passing your ADP or ACP test, we can work with you to design your plan so that it is no longer a worry!