

# ADP / ACP Tests

## Actual Deferral and Contribution Percentage Tests



401(k) Plans not designed as “Safe Harbor” Plans are required to pass the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) Tests each year. This document provides general information about these tests.

### Why is this Test Required?

401(k) Plans were created by Congress as a system to help U.S. workers save for retirement. Special tax incentives are provided to encourage employers to adopt plans, promote savings, and make contributions. The ADP and ACP Tests is one method of ensuring that employers promote savings among all workers and not just among owners and key executives.

### How is the Test Calculated?

These tests group eligible participants into two categories – (1) Highly Compensated Employees (HCEs), and (2) Non-Highly Compensated Employees (NHCEs) and compare the contribution rates for each group. A plan is deemed to pass if the average contribution rate of the HCEs does not exceed the average contribution rate of the NHCEs by (1) no more than 2% or (2) no more than two times the amount funded by the NHCE group.

**ADP Test** – The ADP Test is calculated for employee salary deferrals.

**ACP Test** – The ACP Test is calculated for employer matching contributions.

**HCE Definition** – An HCE is defined by Internal Revenue Service Regulations. In general, an employee is considered an HCE if they (1) own 5% or more of the company or (2) earned more than \$120,000<sup>1</sup> in the preceding year. There are other parts of this definition that might cause an employee to be considered an HCE, including certain family relationships with an owner and other complex factors.

<sup>1</sup> The HCE Compensation Limit is indexed annually for inflation. The amount for 2017 is \$120,000.

**Current vs. Prior Year Testing** – Plans can be designed to either use Current or Prior Year Testing. Current Year Testing uses the current year deferral rate of NHCEs and the Prior Year Method uses the prior year rates.

### Methods for Correcting a Failed Test

If a Plan fails, the employer must “correct” the failed test to ensure the plan keeps its tax-qualified status. Corrections are generally made by refunding excess amounts to the HCEs to reduce their contribution rate. Some plans may also have the option of making additional contributions to the NHCEs to correct a failed test. For a calendar year plan to correct a failed test without penalty, the plan must process refunds by March 15<sup>th</sup> following the plan year-end in question or corrective contributions must be funded by December 31<sup>st</sup>.

### Strategies to Avoid Failing

There are a number of strategies employers can use to reduce the likelihood of failing the ADP or ACP test.

- **Modify Matching Formula** – Employers may be able to modify the matching formula to increase participation and help the plan pass.
- **Promote the Plan** - Employers can promote the plan to increase participation.
- **Change to “Safe Harbor”** – Employers that wish to eliminate ADP and ACP testing can modify their plan design to become a “Safe Harbor 401(k) Plan”.
- **Auto-Enrollment Feature** – Plans can be amended to include an Automatic Enrollment feature. These plans automatically enroll participants at a pre-defined deferral percentage. These plans have become a popular method of increasing plan participation.

Please contact JULY at [888.333.5859](tel:888.333.5859) for more information.