

## ADP/ACP Discrimination Testing for 401(k) Plans

### What are ADP/ACP Tests?

The ADP (Actual Deferral Percentage) and ACP (Actual Contribution Percentage) tests compare the average of salary deferral and employer match percentages for highly compensated employees (HCE) to the average of salary deferral and employer match percentages for non-highly compensated employees (NHCE).

HCE's include anyone who owns more than 5% of the company (and certain family members), or anyone who received more than \$110,000 (indexed) in gross compensation from the employer in the previous year. There is no minimum income required for a more than 5% owner or family member to be classified as an HCE. For example, they could earn only \$1,000 and still be classified as an HCE.

To perform the ADP test, a salary deferral percentage is calculated for every eligible employee. The numerator is the amount of salary deferred by the employee. The denominator is the employee's pay before salary deferral. The employees are then grouped into HCE's and NHCE's. The percentages are added together and an average is calculated. Eligible participants who did not contribute to the plan are included as zeros.

The example below shows a calculation for an NHCE group. The ACP test is calculated in the same manner, except the numerator is the dollar amount of matching contributions to the employee's account.

	Salary	Deferral	ADR
Employee #1	\$25,000	\$1,000	4.00%
Employee #2	\$33,000	\$2,500	7.58%
Employee #3	\$25,000	\$0	0.00%
Employee #4	\$35,000	\$3,000	8.57%
Employee #5	\$28,000	\$1,500	5.36%

Average ADP 5.10%

Once the averages have been calculated, the HCE average is compared to the NHCE average. As a general rule, the HCE average cannot exceed the NHCE average by more than 2%. There are more restrictive rules if the NHCE average is less than 2%.

If the tests are not satisfied, a correction must be made. There are two ways to correct a failed ADP or ACP test. The employer can make a contribution to the plan to raise the NHCE average so that the test passes or return a part of the HCE's contribution to lower the HCE average so that the test passes. The best method to use depends on the individual circumstances of each plan. The Plan Administrator is responsible for deciding which method is to be used to correct the test.

### Avoiding the Testing

Employers can avoid the ADP/ACP testing by utilizing a "Safe Harbor 401(k)" design. There are 2 basic Safe Harbor designs. The first is a fully vested 3% employer contribution for all participants (whether they use the 401(k) or not). The second is a fully vested matching contribution. The Safe Harbor match is a dollar for dollar match up to 3% of pay and 50 cents on the dollar on the next 2% of pay.

An amendment to the plan is required to add Safe Harbor provisions and many other requirements apply. Contact us if you are interested in more information on either the basic testing or how to avoid it.

**NOTE: This piece is an overview only. ADP/ACP testing is complex and this is intended as a basic introduction to the concept.**