

# 401(k) Plan ADP/ACP Testing

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## ***What is the ADP test?***

*ADP stands for Average Deferral Percentage. 401(k) plans are required to perform this test each year. To maintain their tax-qualified status, the test must be passed. Very briefly, to perform the test, the employees who are eligible to defer are divided into two groups, Highly Compensated Employees and Non-Highly Compensated Employees. The percentage of salary contributed to the plan is calculated for each eligible participant, and these percentages are then averaged for each group. The average percentage for the Highly Compensated Employees may exceed the average percentage for the Non-Highly Compensated Employees, but only by a limited amount. If the difference is too great, the percentages must be adjusted until the test is passed. The most common way to do this is by refunding contributions made by Highly Compensated Employees. Other methods include increasing plan contributions to Non-Highly Compensated Employees, depending on the specific plan.*

## **Who are Highly Compensated Employees?**

Highly Compensated Employees (HCEs) are generally those employees who own more than 5% of the company, or who earned over a statutory dollar limit, indexed for inflation, in the immediately preceding plan year (\$100,000 in 2007 for testing in 2008; \$105,000 in 2008 for testing in 2009).

## **How are the refunded contributions determined?**

The IRS has specific rules on how the refund amounts are calculated. The calculation of refunds begins with the Highly Compensated Employee with the highest *dollar amount* contribution. His or her contribution is lowered first, to the dollar level of the next highest HCE's contribution. Then both contributions are lowered together until reaching the next highest HCE's dollar level, and so on, until the total dollar amount of refunds returned equals that determined under the IRS procedure for calculating the refund amount. It is important to note that the employer cannot determine who gets a contribution refunded. It is determined only by IRS rules.

## **What are the tax effects of the contribution refund?**

The intended effect of the refund is to restore each participant and the plan to the financial position they would have been in had the contributions been limited to pass 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. The employees still benefit from the tax-deferral on the contributions not refunded. This adjustment preserves the tax-qualified status of the plan, and the tax deferral of

contributions and earnings that remain in the plan. The fact that a refund is necessary is not an indication of some failure on the part of the plan sponsor or administrator; it is just an adjustment to limit the contributions of the Highly Compensated Employees to the appropriate amount as specified in the Internal Revenue Code.

### ***For plan years beginning before January 1, 2008 -***

The refunds, if distributed within 2½ months of the plan year end, are taxable to the participant as compensation in the year the salary deferral was originally paid. The refunded contributions will include a small adjustment for any investment earnings/losses during the year to put the plan in the same position it would have been in had the contributions not been made in the first place. If the refund is not distributed within 2½ months of the year end, they must still be distributed within 12 months of the year end and are taxable in the year distributed; however the excess contributions are subject to a 10% excise tax assessed on the plan sponsor. It is important that the ADP testing be done soon enough to allow time for the plan's investment provider to pay these refunds within the 2½ month time frame to avoid this excise tax. If the plan year does not coincide with the calendar year, the employer may elect to delay the refunds and pay the excise tax so that the HCEs do not need to amend their prior year personal tax return.

### ***For plan years beginning after December 31, 2007 -***

The refund is taxable in the year distributed. The refunded contributions will include a small adjustment for any investment earnings/losses during the year to put the plan in the same position it would have been in had the contributions not been made in the first place. They must still be distributed within 12 months of the year end. If the refunds are not 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 – automatic enrolment plans) the excise tax is due if the refunds are not paid within 6 months after the plan year end. It is important that the ADP testing be done soon enough to allow time for the plan's investment provider to pay these refunds within the 2½ month or 6 month time frame to avoid this excise tax.

### **What other methods are available to correct a failed ADP test?**

In addition to refunds of excess contributions, most 401(k) plans allow the employer to make a "fail-safe" contribution. Contributions can be made to the Non-Highly Compensated Employees to increase the average of their deferral percentages, until the plan meets the ADP test. These contributions must be allocated to the Non-Highly Compensated Employees in the manner specified in the plan document and are called Qualified Non-Elective Contributions (QNECs). Only plans that use the "current year testing method" may use this method.

### **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?**

ACP stands for Average Contribution Percentage. 401(k) plans that have match contributions or after-tax voluntary employee contributions are required to perform this test each year. To maintain their tax-qualified status, the test must be passed.

The ACP tests match contributions and voluntary employee contributions are tested in exactly the same manner as the ADP tests 401(k) deferrals. All participants who are eligible to receive a match contribution, and those who make a voluntary employee contribution, are included in the test. Participants who meet all the requirements to receive a match contribution except that they elected not to defer are also included in the testing.

## **What methods are available to correct a failed ACP test?**

A failed ACP test is corrected using one of the methods used to correct a failed ADP test. Excess match or voluntary employee contributions may be refunded to Highly Compensated Employees or the employer may make a QMAC (Qualified Match Contribution) contribution to Non-Highly Compensated Employees. The taxation of the refunds and whether the employer must pay an excise tax depends on when the refunds are paid, just as with refunds of excess 401(k) deferrals. The ACP test must also be corrected within 12 months following the end of the plan year.