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Actual Deferral Percentage (ADP) Testing

An Overview

401(k) plans are subject to special coverage and nondiscrimination testing to prevent plans from overly favoring highly compensated employees (HCEs). These testing requirements are some of the most complex elements of 401(k) plan administration. The first test a plan must pass is the IRC §410(b) coverage test. Coverage testing assesses whether a plan covers sufficient rank and file employees to be considered broad-based. Once coverage testing is passed, the actual deferral percentage (ADP) test must be performed. The ADP test uses mathematical techniques to compare the contribution rates of the HCEs to those of the non-highly compensated employees (NHCEs). An employer that wants to avoid nondiscrimination testing altogether has an alternative: the Internal Revenue Code provides certain safe harbor plan designs that permit employers to bypass ADP testing entirely.

Highly Compensated Employees

Generally, a highly compensated employee is an employee who falls into either of the following two categories:

- An owner of more than 5% of the business in the testing year or the prior year (family stock attribution rules apply which treat an individual as owning stock owned by his/her spouse, children, grandchildren or parents); or
- An employee who received compensation in excess of a specified limit from the employer in the prior year (e.g., employees who earned more than $125,000 in 2019 will be considered HCEs in 2020). The Employer may elect to limit the number of HCEs by compensation to the top 20% of employees based on pay, which may be a particularly effective tactic in small plans maintained by professional groups such as law firms and physicians (more on this below).

Performing the ADP Test

The nondiscrimination rules require the average deferral rate for the HCEs to be within a specified range of the average deferral rate for the NHCEs. The ADP test is performed on the basis of the plan year, and the ADP limit for the HCE group is set by the ADP of the NHCE group.

The ADP for each group is determined by taking the average of the actual deferral ratios (ADRs) separately calculated for each eligible employee. An eligible employee includes every employee who is eligible to make a 401(k) contribution, regardless of whether the employee actually elects to contribute. Each participant's ADR is the percentage of his or her compensation that has been contributed to the plan through the 401(k) arrangement (including Roth 401(k) but excluding catch-up contributions).

After the ADRs are calculated for each eligible employee, the average of these ratios generates the ADP for both the HCE group and the NHCE group. Below is an example to illustrate:

ADRs Averaged to the NHCEs' ADP			
NHCE	**Compensation**	**Deferral**	**ADR**
1	$70,000	$4,000	5.71%
2	$28,000	$0	0%
3	$30,000	$800	2.67%
4	$10,000	$0	0%
5	$47,000	$2,000	4.26%
NHCEs' ADP Determined:	**(5.71% +0%+2.67%+0%+4.26%) = 12.6% divided by 5 = *2.53% NHCEs' ADP***		

For the HCEs, the same process is used to arrive at the HCEs' ADP. Once both the NHCE and the HCE ADP figures have been determined, they are compared against each other. The HCEs' ADP may only exceed the NHCEs' ADP by specific limits. The limits are summarized as follows:

ADP Test Limits	
NHCEs' ADP	**Maximum HCE limit**
0 to 2%	2 times the NHCE limit
2% to 8%	Add 2 to the NHCE limit
> 8%	1.25 times the NHCE limit

Using our example in which the NHCEs' ADP is 2.53%, the HCEs' ADP is limited to 2.53% plus 2% for a maximum of 4.53%.

The ADP test must be performed using the entire year's compensation and deferrals, and thus, cannot be completed before year-end (but may be estimated prior to year-end).

Correction of Testing Failures

Plans that do not pass the ADP test must take some action, such as making corrective distributions or additional employer contributions.

Most often, plans correct a failed ADP test by making corrective distributions of excess contributions, plus earnings. Corrective distribution amounts are determined by a leveling method and are allocated among the HCEs based on the dollar amount of their contributions. If the plan permits catch-up contributions and the participant is age 50 or older with unused catch-up contributions, the ADP refund is first offset by any unused catch-up amounts.

Corrective distributions generally must be completed within 2½ months after the close of the plan year being tested in order to avoid a 10% excise tax penalty payable by the employer (plans that meet the Eligible Automatic Contribution Requirements post-2008 have 6 months to make corrective distributions). Plans that make corrective distributions prior to the close of the following plan year but after the applicable 2½ month or 6 month deadline, still comply with all qualification rules, but are subject to the 10% excise tax.

Excess contributions must be adjusted for allocable earnings through the end of the plan year being tested (net gains or losses for the plan year that are attributed to the excess contributions). Corrective distributions are taxable in the year in which they are distributed.

In some situations, the employer may elect to correct a failed ADP test by making qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) to NHCEs to increase their ADP to the level needed for the HCEs to pass the test. QNECs and QMACs must be deposited into the plan by the last day of the following plan year, are required to be 100% vested immediately, and are subject to certain withdrawal restrictions.

Additional Considerations

There are several additional factors that may influence the results of the ADP test, including the following:

- The Plan's definition of compensation;
- Whether the current year or prior year testing method is used;
- Whether the 20% top-paid group option is used to limit the number of HCEs; and
- Whether plans that allow employees to participate before they attain age 21 and complete one year of service elect to use special testing rules known as disaggregation.

Definition of Compensation

The definition of compensation impacts the calculation of the ADRs. The following issues need to be addressed when determining testing strategies:

Does the definition of compensation in the plan document for testing purposes include pre-tax contributions? Effectively, is the employer using “gross” or “net” compensation for testing?

This choice may dramatically affect the ADR calculation. For example, in a plan using a testing compensation definition that excludes pre-tax contributions, a participant with compensation of $50,000 who defers $5,000 will have an ADR of 11.11% ($5,000 divided by $45,000). If pre-tax contributions were included in the test, the ADR for this individual would be 10% ($5,000 divided by $50,000). Individuals earning in excess of the annual compensation cap are tested by using the capped amount.

In the year a participant enters the plan, what is the definition of compensation for the year of entry? Is compensation taken into account for the entire year or is it limited to the time the employee actually participated in the plan?

This will depend on plan design. In general, if the compensation calculation period is defined as “plan year while a participant,” compensation included will be limited to that received while the individual was actually participating. This too will have a dramatic effect on the ADR calculation. For example, in a calendar year plan, if compensation is defined as that received while a participant (instead of an alternate definition such as the entire plan year, the calendar year or the employer’s fiscal year) an employee who earned $60,000 during the entire plan year but only entered the plan on July 1 would be limited to a half year’s compensation in the ADR calculation. If this participant deferred $3,000, the ADR would be 10% ($3,000 divided by $30,000). Had the plan defined compensation as that received during the entire plan year, the ADR would have been 5% ($3,000 divided by $60,000).

Using compensation while a participant generally improves testing results.

Testing Methods

The ADP test must be performed by using either the prior year testing method or the current year testing method. The method must be specified in the plan document.

If the prior year testing method is used, the ADP limit on the HCEs is based on NHCE data from the prior plan year. For example, in a calendar year plan using the prior year method for the 2020 plan year, if the NHCE’s ADP for 2019 was 3%, then the HCE’s ADP for 2020 could not exceed 5%. If the current year testing method is used, the ADP limit on the HCEs is based on NHCE data from the current plan year (2020 in the example above).

The prior year testing method provides employers the ADP limit for HCEs in advance, thus reducing the change of a failed test at year-end. If the current year testing method is used, the HCEs will not know the actual ADP of the NHCEs until after the close of the plan year being tested. Although the current year testing method has less certainty, there are advantages to its use, particularly if the NHCE average increases each year.

A plan may shift from the prior year method to the current year method at any time. However, once the change from the prior year method to the current year method occurs, the plan may not return to prior year method testing for five years.

20% Top Paid Group Election

It is possible to limit the number of HCEs by compensation to the top 20% paid group, which may be a particularly effective tactic in small plans maintained by professional groups such as law firms and physicians.

An example will make it clear. Assume that a company has 20 eligible employees whose compensation, listed in descending order, is as follows:

Employee	2019 Compensation	HCE	HCE under top 20% option
1	$230,000	Yes	Yes
2	$230,000	Yes	Yes
3	$175,000	Yes	Yes
4	$150,000	Yes	Yes
5	$130,000	Yes	No
6	$125,001	Yes	No
7 – 20	<$60,000	No	No

Without the top 20% option, all 6 employees making over $125,000 would be considered HCEs for 2020. However, if the top 20% election were made, only the top 20% would be considered HCEs; and therefore, in this example, instead of 6 HCEs, only the top 4 individuals would be considered HCEs. This eliminates 2 of the HCEs from the HCE average and adds them to the NHCE average for testing purposes. As those with higher incomes generally defer more income, this may result in an increase of the average deferral percentage of the NHCE group while lowering the HCE group percentage.

Disaggregation and Otherwise Excludable Employees

Plans that cover employees sooner than the law requires are permitted to use special testing rules known as disaggregation. Disaggregation is based on the definition of otherwise excludable employees. An otherwise excludable employee is an eligible employee who would not have been an eligible employee if the plan had imposed the maximum one year of service and/or age 21 eligibility requirements. Employees who have completed these maximum eligibility requirements are known as statutory employees.

A plan with more lenient entry requirements may pass coverage testing by using the otherwise excludable employee rule. If the plan uses this rule to test coverage, special testing rules must also be applied to the ADP test. The plan may either:

1. Use the early participation testing method whereby otherwise excludable NHCEs are left out of the ADP test entirely; or
2. Use the disaggregated plans testing method whereby statutory employees and otherwise excludable employees are completely disaggregated and tested separately, as if each group participates in a separate plan.

These special testing rules are intended to encourage employers to liberalize participation requirements in 401(k) plans.