# ADP Test Basics


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# ADP Test Basics

The tax code governing 401(k) plans was written to prevent qualified retirement plans from overly favoring Highly Compensated Employees (HCEs). A series of non-discrimination tests were devised to measure whether a plan's design or operation lends to favoring the HCEs over the Non-Highly Compensated Employees (NHCEs). All year end testing begins with the coverage test in accordance with IRS Code section 410(b). Once the coverage test is passed or, if not passed, once steps have been taken to pass coverage, then the average deferral percentage (ADP) test must be performed. The ADP test uses mathematical equations to compare the participation and contribution rates of the HCEs to the NHCEs in order to determine whether the plan is discriminating in favor of the HCEs.

**Who is considered a Highly Compensated Employee?**

Generally, a highly compensated employee is an employee who is either a more than 5% owner of the business (also known as a 5% owner) in the year of testing or the prior year, or someone who makes more than a specific dollar threshold determined by the IRS and adjusted annually for cost-of-living increases ( for 2014 testing purposes, someone who earns $115,000 or more in 2013). It is possible to further restrict the number of HCEs associated with a particular employer by limiting HCE designation based on a compensation threshold to only the highest paid 20% of employees. This election may be particularly effective for small plans maintained by professional groups such as law firms and physicians. However, this election must be written into the plan document provisions in order to be effective.

The 5% owner rule also requires careful review of the ownership attribution rules for families and trusts. Family attribution rules dictate that the spouse, parent, legal child and grandchild of a more than 5% owner of the company are also considered 5% owners themselves. For example, if John Smith owns 100% of a business that also employs his wife Jane; the family attribution rules dictate that, as hiswife, Jane would also be considered to own 100% of the business. Therefore, both John and Jane would be considered to be HCEs due to either direct or attributed ownership.

**How does the ADP Test work mathematically?**

To perform the ADP test, first determine every employee who is eligible to make an elective deferral regardless of whether they actually contribute. Then you divide this list into groups: HCEs and NHCEs. Starting with the HCEs, each employee's Actual Deferral Ratio (ADR) is determined by dividing the employee's compensation into the amount the employee deferred into the plan. Once each employee's ADR is determined, the ADRs are averaged to arrive at the HCEs' ADP.

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Below is an example to illustrate this process:

| ADRs Averaged to derivethe HCEs' ADP | | | |
|---|---|---|---|
| **HCE** | **Compensation** | **Deferral** | **ADR** |
| 1 | $260,000 | $17,500.00 | 6.73% |
| 2 | $200,000 | $10,000.00 | 5.00% |
| 3 | $150,000 | $7,500.00 | 5.00% |
| 4 | $115,000 | $5,000.00 | 4.35% |
| 5 (Daughter) | $47,000 | $0.00 | 0.00% |
| | | **Average Deferral %** | **4.22%** |

The same process is followed for the NHCE group.

| ADRs Averaged to derive the NHCEs' ADP | | | |
|---|---|---|---|
| **NHCE** | **Compensation** | **Deferral** | **ADR** |
| 1 | $70,000 | $4,000 | 5.71% |
| 2 | $45,000 | $0 | 0.00% |
| 3 | $30,000 | $800 | 2.67% |
| 4 | $28,000 | $0 | 0.00% |
| 5 | $47,000 | $2,000 | 4.26% |
| | | **Average Deferral %** | **2.53%** |

Once both the HCE and the NHCE and 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 may be 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%. This test passes as the HCE average is 4.22%

**Timing of the test**

In general, the ADP testing should be completed within 2½ months after the end of the plan year. The typical correction for a failing test involves the distribution of excess contributions to the HCEs until the point at which the test is satisfied. In order to avoid an excise tax penalty, the plan sponsor is required to process these refund distributions by no later than 2 ½ months after the plan year end date. If the plan document allows for it, a failing test may also be remedied by the plan sponsor contributing a Qualified Non-Elective Contribution (QNEC) to the NHCEs to raise their average to a passing result.