



Understanding ACP and ADP Testing:

A GUIDE FOR PLAN SPONSORS >

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As a plan sponsor, compliance with IRS nondiscrimination tests is crucial for maintaining your 401(k) plan's qualified status. Key tests include the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests. This guide offers a concise overview of these tests, their importance, and management strategies. The record-keeper or third-party administrator (TPA) on the plan performs that testing at year-end.

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ADP TESTING >

Purpose:

Ensures that Highly Compensated Employees (HCEs) do not defer a disproportionately higher percentage of their salary compared to Non-Highly Compensated Employees (NHCEs).

Calculation

Compare average deferral rates of HCEs and NHCEs to IRS limits.

ACP TESTING >

Purpose:

Focuses on employer matching and employee after-tax contributions.

Calculation

Compare average contribution rates, including matching and after-tax contributions, for HCEs and NHCEs.

IMPORTANCE OF THESE TESTS

Compliance

Essential for maintaining the tax-qualified status of your 401(k) plan.

Fairness

Ensures equitable distribution of retirement benefits, preventing discrimination in favor of HCEs.

WHO ARE HIGHLY COMPENSATED EMPLOYEES (HCEs)?



Employees who:

- Owned more than 5% of the business during the current or preceding year, or
 - Spouses, Children, Parents and Grandchildren of an employee who owns more than 5% are considered HCE even if they do not meet the wage requirement.
- Earned over a certain threshold (e.g., \$160,000 in 2025, subject to annual adjustments).

STRATEGIES TO PASS ADP AND ACP TESTS



Safe Harbor Contribution:

- Automatically satisfy ADP and ACP testing requirements., which ensures that HCE's do not disproportionately benefit from the plan compared to NHCE's. Employers make specific mandatory contributions, either matching or non-elective, to employees' accounts.
- Automatic Enrollment: Increase participation amount for NHCE.
- Matching Contribution: structured to incentivize higher deferral rates among NHCEs.
- Education and Communication: Encourage higher participation and deferral rates among NHCEs.

WHAT HAPPENS WHEN TESTS FAIL?



Corrective Measures

- If a plan fails either the ADP or ACP test, corrective measures must be taken to bring the plan into compliance. This typically involves refunding excess contributions for HCEs.

REFUNDS OF CONTRIBUTIONS:



Process:

- **Identification:** The tests identify the excess contributions made by HCEs.
- **Calculation:** The excess amount is calculated based on the difference required to pass the nondiscrimination tests.
- **Distribution:** Refunds are issued to HCEs for the excess contributions. These refunds are typically subject to income tax and may incur penalties if not corrected within specific timeframes

Impact on Participants:

- **Tax Implications:** Refunds are considered taxable for the year in which they are received.
- **Plan Adjustments:** The plan may need to adjust contribution strategies or limits to prevent future test failures.

Conclusion

Managing ADP and ACP testing is vital for compliance and fairness in your 401(k) plan. Consider strategic options to maintain the plan's integrity and benefits. For detailed guidance, consult a retirement plan advisor or legal expert in employee benefits.

This concise guide provides an overview of ADP and ACP testing for plan sponsors. For specific assistance, professional consultation is recommended.

Additional Resource

[401\(k\) plan Fix-it Guide – The plan failed the 401\(k\) ADP and ACP nondiscrimination tests | Internal Revenue Service](#)

