

ADP / ACP Non-Discrimination Tests

401(k) plans are subject to special non-discrimination testing. These tests are designed to limit the extent to which salary deferral and matching contributions of the highly compensated employees may exceed salary deferral and matching contributions of the non-highly compensated employees. Under the Average Deferral Percentage (ADP)/Average Contribution Percentage (ACP) tests all eligible employees are divided into two categories – the Highly Compensated Employees (HCE) and the Non-Highly Compensated Employees (NHCE).

An employee is considered highly compensated if either of the following is satisfied:

- 1.) Employee is a 5% or more owner at any time during the year or the preceding year, or
- 2.) Employee had compensation for the preceding year more than \$130,000 (indexed every year)
- 3.) Employee family members of a 5% owner or more

All eligible employees, other than Highly Compensated Employees, are considered Non-Highly Compensated Employees.

The first step in computing the ADP/ACP tests is to calculate the average deferral percentage for the NCE group. Once that figure is calculated, subject to certain limitations, the maximum allowable average deferral percentage for the HCE group can then be determined using the following table:

NHCE Group's Average ADP/ACP	Maximum Allowable Average ADP/ACP for HCE Group
Less than 2%	2 x NHCE ADP/ACP
2% - 8%	2% + NHCE ADP/ACP
More than 8%	1.25 x NHCE ADP/ACP

If the average deferral percentage for the highly compensated group is equal to or less than the maximum allowable average rate, the tests pass. If the percentage is higher, the tests fail.

If the tests fail, the regulations provide two mechanisms for the employer to correct a failing test. The first is to contribute a fully vested employer contribution to the eligible *Non-Highly Compensated Employees* at a rate that would make the tests pass. The second is to have the plan return sufficient salary deferrals or matching contributions to the *Highly Compensated Employees* affected so that the tests pass. The HCE's receiving returns would then have to claim those contributions as personal income when filing tax returns.

It should be possible for companies to determine, with relative certainty, the amount that its HCE group can collectively contribute. The reason is that 401(k) plans can determine the HCE maximum allowable rate for the *current* year by using the actual ADP/ACP of the NHCE group from the *prior* year.

HCE Compensation levels Indexed:

Type of Limitation	2020	2019	2018	2017	2016	2015	2014	2013	2012
Highly Compensated (Lookback year Calculation)	130,000	125,000	120,000	120,000	120,000	120,000	115,000	115,000	115,000