

ADP Testing: Conquering the Calculations

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Noteworthy Caution: This material is not intended to be comprehensive. It was prepared to present a basic understanding of ADP testing. The author recommends this material not be relied upon as your only guidance.

ADP Test Illustration

ADP Test demonstrates elective deferral contributions under IRC Section 401(k) satisfy nondiscrimination under IRC Section 401(a)(4). Performed on a plan year basis and required for any plan year when 401(k) elective deferrals are made.

Include in the test employees who are eligible to contribute elective deferrals for any portion of the plan year.

ADP Test limits the average deferral percentage (ADP) of *highly compensated employees* (HCEs) based on the ADP of *nonhighly compensated employees* (NHCEs).

Two different "tests" must be performed to determine the HCE ADP limit: (1) 1.25 test and (2) alternate limit test using 2% spread.

A	B	C	D=C/B	E	F
Participant	2001 Compensation	2001 Elective Deferrals	ADR Actual Deferral Ratio	Sum of ADRs by Group	ADP Average Deferral Percentage
HCE 1	150,000.00	10,500.00	7.00%		
HCE 2	100,000.00	8,000.00	8.00%		
HCE 3	90,000.00	5,400.00	6.00%		
				21.00%	21.00% / 3 = 7.00%
NHCE 1	60,000.00	3,600.00	6.00%		
NHCE 2	50,000.00	6,000.00	12.00%		
NHCE 3	40,000.00	0.00	0.00%		
NHCE 4	30,000.00	2,700.00	9.00%		
NHCE 5	20,000.00	0.00	0.00%		
NHCE 6	15,000.00	450.00	3.00%		
				30.00%	30.00% / 6 = 5.00%

HCE ADP is limited to:			
Greater of:		Greater of:	Limit
(1)* NHCE ADP times 1.25	5.00% times 1.25 =	6.25%	7.00%
OR			
(2)* lesser of:	lesser of:	7.00%	
(a) NHCE ADP plus 2.00%	5.00% plus 2.00% = 7.00%		
(b) NHCE ADP times 2.00%	5.00% times 2.00% = 10.00%		

**Conclusion: Based on the NHCE ADP of 5.00%, the HCE ADP is limited to 7.00%.
Since the HCE ADP of 7.00% does not exceed the limit, ADP Test PASSES!**

* (1) is the 1.25% test and (2) is the alternate limit test using the 2% spread.

Note: ADP Test passes using the 2% spread.

ACP Test Illustration

ACP Test uses the same testing methodology as the ADP Test but tests different contributions.

ACP Test demonstrates employer match and employee after-tax contributions satisfy nondiscrimination under IRC Section 401(a)(4).

Performed on a plan year basis and required for any plan year when employer match or employee after-tax contributions are made.

Include in the test employees who are eligible for the employer match and/or who are eligible to contribute employee after-tax contributions for any portion of the plan year.

Test limits the average contribution percentage (ACP) of *highly compensated employees* (HCEs) based on the ACP of *nonhighly compensated employees* (NHCEs).

Two different "tests" must be performed to determine the HCE ACP limit: (1) 1.25 test and (2) alternate limit test using 2% spread.

Assumptions:

Use the same census data as in the previous ADP Test Illustration.

Match formula is 50% of 401(k) elective deferrals up to first 6% of compensation (i.e. match limited to 3% of compensation).

All eligible employees who contribute 401(k) elective deferrals are eligible for the match.

Match is subject to a vesting schedule and the plan does not permit employee after-tax contributions.

A	B	C	D	E=D/B	F	G
Participant	2001 Compensation	2001 Elective Deferrals	2001 Employer Match	ACR Actual Contribution Ratio	Sum of ACRs by Group	ACP Average Contribution Percentage
HCE 1	150,000.00	10,500.00	4,500.00	3.00%		
HCE 2	100,000.00	8,000.00	3,000.00	3.00%		
HCE 3	90,000.00	5,400.00	2,700.00	3.00%		
					9.00%	9.00% / 3 = 3.00%
NHCE 1	60,000.00	3,600.00	1,800.00	3.00%		
NHCE 2	50,000.00	6,000.00	1,500.00	3.00%		
NHCE 3	40,000.00	0.00	0.00	0.00%		
NHCE 4	30,000.00	2,700.00	900.00	3.00%		
NHCE 5	20,000.00	0.00	0.00	0.00%		
NHCE 6	15,000.00	450.00	225.00	1.50%		
					10.50%	10.50% / 6 = 1.75%

HCE ACP is limited to:			
Greater of:		Greater of:	Limit
(1) NHCE ACP times 1.25	1.75% times 1.25 =	2.19%	3.50%
OR			
(2) lesser of:	lesser of:	3.50%	
(a) NHCE ACP plus 2.00%	1.75% plus 2.00% = 3.75%		
(b) NHCE ACP times 2.00%	1.75% times 2.00% = 3.50%		

Conclusion: Based on the NHCE ACP of 1.75%, the HCE ACP is limited to 3.50%.

Since the HCE ACP of 3.00% does not exceed the limit, ACP Test PASSES!

Note: ACP Test passes using the 2% spread.

Multiple Use Test Illustration

Multiple Use Test limits the use of the 2% spread to pass both the ADP Test and the ACP Test.

Performed on a plan year basis and generally required when both an ADP Test and an ACP Test are required for the same plan year AND both the ADP Test and ACP Test pass using the 2% spread.

If ADP Test or ACP Test can pass limiting the HCE average percentage to 1.25% times the NHCE average percentage, Multiple Use Test is not required.

In previous illustrations, neither the ADP Test nor the ACP Test passes the 1.25% test.

Since both the ADP Test and the ACP Test pass using the 2% spread, the Multiple Use Test is required.

Previous ADP and ACP Test Illustrations:

	ADP	ACP
HCE	7.00%	3.00%
NHCE	5.00%	1.75%

HCE ADP plus HCE ACP is limited to:			Greater of:	Limit
Greater of:				
(1) NHCE (greater of ADP or ACP) times 1.25 plus lesser of: (a) NHCE (lesser of ADP or ACP) plus 2.00% (b) NHCE (lesser of ADP or ACP) times 2.00%	5.00% times 1.25 = lesser of: 1.75% plus 2.00%= 3.75% 1.75% times 2.00%= 3.50%	6.25% + 3.50%	9.75%	
OR				9.75%
(2) NHCE (lesser of ADP or ACP) times 1.25 plus lesser of: (a) NHCE (greater of ADP or ACP) plus 2.00% (b) NHCE (greater of ADP or ACP) times 2.00%	1.75% times 1.25 = lesser of: 5.00% plus 2.00%= 7.00% 5.00% times 2.00%= 10.00%	2.19% + 7.00%	9.19%	

**Conclusion: Based on the NHCE ADP of 5.00% and NHCE ACP of 1.75%, HCE ADP plus HCE ACP limited to 9.75%
 HCE ADP of 7.00% plus HCE ACP of 3.00% equals 10.00%.
 Since 10.00% exceeds the limit of 9.75%, Multiple Use Test FAILS!**

Note: ADP Test passes, ACP Test passes but Multiple Use Test fails.

Current Year vs. Prior Year Testing Method

There is more than one permissible way the ADP Test and ACP Test may be performed.

Performing the ADP Test and/or ACP Test using permissible alternatives may prevent a failing test.

During the *GUST remedial amendment period*, switching between the Current Year and Prior Year Testing Method from plan year to plan year is permissible.

Current Year Testing Method

The limit for the HCE ADP (HCE ACP) is based on the NHCE ADP (NHCE ACP) for the same year (i.e. the testing year).

Note: The previous ADP Test and ACP Test illustrations use the current year testing method.

Prior Year Testing Method

The limit for the HCE ADP (HCE ACP) is based on the NHCE ADP (NHCE ACP) from the year prior to the testing year.

The Small Business Job Protection Act of 1996 made this method the default effective for plan years beginning on or after January 1, 1997.

Note: For plan years prior to 1997, only the current year testing method was available.

Previous **2001** ADP and ACP Test Illustrations:

	ADP	ACP
HCE	7.00%	3.00%
NHCE	5.00%	1.75%

Assume **2000** ADP and ACP Test Results were:

	ADP	ACP
HCE	7.25%	2.75%
NHCE	6.00%	2.00%

Using Prior Year Testing Method for 2001 Plan Year:

	ADP	ACP	
HCE	7.00%	3.00%	From 2001
NHCE	6.00%	2.00%	From 2000

IMPORTANT: HCE ADP and ACP are always from the testing year.

Results using Current Year Testing Method from previous illustrations: ADP Test passes, ACP Test passes but Multiple Use Test fails.

Results using Prior Year Testing method:

ADP Test:
HCE ADP of 7.00% is limited to:
Greater of:
(1) NHCE ADP of 6.00% times 1.25 = 7.50%
OR
(2) lesser of:
 (a) NHCE ADP of 6.00% + 2.00% = 8.00%
 (b) NHCE ADP of 6.00% times 2.00% = 12.00%
Since HCE ADP of 7.00% does not exceed 8.00%,
ADP Test PASSES!

ACP Test:
HCE ACP of 3.00% is limited to:
Greater of:
(1) NHCE ACP of 2.00% times 1.25 = 2.50%
OR
(2) lesser of:
 (a) NHCE ADP of 2.00% + 2.00% = 4.00%
 (b) NHCE ADP of 2.00% times 2.00% = 4.00%
Since HCE ACP of 3.00% does not exceed 4.00%,
ACP Test PASSES!

Multiple Use Test: Since the ADP Test passes using the 1.25 test, the Multiple Use Test is not required.

Conclusion: Multiple Use Test failed using the current year testing method, but is not required using the prior year testing method. By using the prior year testing method, a failed Multiple Use Test is prevented.

For further guidance on prior year and current year testing methods, refer to IRS Notices 97-2 and 98-1.

Disaggregation Rules

There is more than one permissible way the ADP Test and ACP Test may be performed.

Performing the ADP Test and/or ACP Test using permissible alternatives may prevent a failing test.

If the plan's eligibility provisions are more liberal than what is required by the statute, disaggregation may be a permissible option.

Disaggregation is permitted under two different IRC Sections.

Disaggregation under IRC Section 410(b)(4)

Assuming applicable coverage tests are passed, plan may be disaggregated and tested as two plans.

Test the *otherwise excludable employees* separately from all other eligible employees.

Otherwise excludable employees are eligible employees who do not satisfy the statutory maximum eligibility requirements (generally one year of service and age 21).

ADP Test before using disaggregation rules

Assumptions:

Employees eligible for 401(k) elective deferrals on date of hire.

Use the same ADRs as the ADP Test illustration on page 2 EXCEPT:

Change ADR for NHCE 2 from 12.00% to 6.00%

Participant	Age	Years of Service	ADR	Sum ADRs by Group	ADP
HCE 1	42	15	7.00%		
HCE 2	54	3	8.00%		
HCE 3	36	5	6.00%		
				21.00%	21.00%/3= 7.00%
NHCE 1	38	15	6.00%		
NHCE 2	45	7	6.00%		
NHCE 3	25	6 months	0.00%		
NHCE 4	31	2	9.00%		
NHCE 5	42	4	0.00%		
NHCE 6	19	2	3.00%		
				24.00%	24.00%/6= 4.00%

HCE limit is 6.00%. ADP Test FAILS!

Using Disaggregation under IRC Section 410(b)(4)

Separate eligible employees into two groups and perform two tests

Group 1 - Eligible employees over one year of service and age 21.

Participant	Age	Years of Service	ADR	Sum ADRs by Group	ADP
HCE 1	42	15	7.00%		
HCE 2	54	3	8.00%		
HCE 3	36	5	6.00%		
				21.00%	21.00%/3= 7.00%
NHCE 1	38	15	6.00%		
NHCE 2	45	7	6.00%		
NHCE 4	31	2	9.00%		
NHCE 5	42	4	3.00%		

HCE limit is 8.00%. ADP Test PASSES!

Group 2 - Eligible employees with less than one year or service and under age 21.

Participant	Age	Years of Service	ADR
NHCE 3	25	6 months	0.00%
NHCE 6	19	2	0.00%

Since there are no HCEs in this group, ADP Test PASSES!

Conclusion: ADP Test passes using disaggregation under IRC Section 410(b)(4). By using disaggregation, a failed ADP Test is prevented.

Disaggregation under IRC Section 401(k)(3)(F)

May disaggregate otherwise excludable employees who are NHCEs and exclude from ADP Test [and ACP Test under IRC Section 401(m)(5)(C)].

Must include all eligible HCEs in testing even if HCE has not met the statutory maximum eligibility requirements.

First available for plan years beginning on or after January 1, 1999.

In example above, NHCE 3 and NHCE 6 may be disaggregated and excluded from testing. Only one ADP Test needs to be performed.

NOTEWORTHY: The disaggregated employees are not necessarily the same group of employees under IRC Section 410(b)(4) and IRC Section 401(k)(3)(F).

Under 401(k)(3)(F), HCEs may never be disaggregated. Under 410(b)(4), otherwise excludable HCEs are disaggregated and included in separate test.

Also, there is on-going debate that the entry date provisions may be applied differently when determining the otherwise excludable employees.

Corrective Distributions to HCEs

If ADP Test and/or ACP Test and/or Multiple Use Test fails, corrective action is required.

The correction period for a plan year is the 12 months following the end of the plan year.

One permissible method of correction is to make distributions to HCEs.

Corrective distributions due to a failed ADP Test are a refund of 401(k) elective deferrals and are called *excess contributions*.

Corrective distributions due to a failed ACP Test are a refund of employer match or employee after-tax contributions and are called *excess aggregate contributions*.

Corrective distributions due to a failed Multiple Use Test are either excess contributions or excess aggregate contributions or both.

The *Leveling Method* is used to determine the total amount of corrective distributions and the amount to distribute to each HCE.

Using the same census as the ADP Test Illustration on page 6 EXCEPT:

Assume all eligible employees satisfy the statutory maximum eligibility requirements

Participant	2001 Compensation	2001 Elective Deferrals	ADR Actual Deferral Ratio	ADP Average Deferral Percentage
HCE 1	150,000.00	10,500.00	7.00%	
HCE 2	100,000.00	8,000.00	8.00%	
HCE 3	90,000.00	5,400.00	6.00%	
				7.00%
NHCE Group				4.00%

HCE limit is 6.00%. ADP Test FAILS!

FIRST Determine Total Amount of Excess Contributions - uses Leveling Method based on PERCENTAGES

Goal: Find the PERCENTAGE (ADR) for each HCE which results in an HCE ADP equal to 6.00% (i.e. the allowable limit).

Start with the HCE(s) with the highest ADR and reduce the ADR until: (1) the ADP Test passes or (2) you reach the HCE(s) with the next highest ADR.

If you reach the HCE(s) with the next highest ADR, proportionately reduce the ADRs for the HCEs until:

(1) the ADP Test passes or (2) you reach the HCEs with the next highest ADR.

Continue until the ADP Test passes and then based on the adjusted ADRs, determine the total amount of the excess contributions.

A Participant	B 2001 Compensation	C 2001 Elective Deferrals	D=C/B ADR Actual Deferral Ratio	E Adjust ADR for HCE 2	F Adjust ADR for HCE 2 and HCE 1	G=FxB Adjusted Elective Deferrals	H=C-G Excess Contribution Amount
HCE 1	150,000.00	10,500.00	7.00%	7.00%	6.00%	9,000.00	1,500.00
HCE 2	100,000.00	8,000.00	8.00%	7.00%	6.00%	6,000.00	2,000.00
HCE 3	90,000.00	5,400.00	6.00%	6.00%	6.00%	5,400.00	0.00
Total	340,000.00	23,900.00				20,400.00	3,500.00
ADP			7.00%	6.67%	6.00%		

FAILS!

FAILS!

PASSES!

Here is total amount to distribute.

See next page for which HCE(s) get it.

For further guidance on the Leveling Method, refer to IRS Notices 97-2.

QNECs and QMACs to NHCEs

If ADP Test and/or ACP Test and/or Multiple Use Test fails, corrective action is required.

The correction period for a plan year is the 12 months following the end of the plan year.

One permissible method of correction is for the employer to make *qualified nonelective contributions* (QNECs).

QNECs must be fully vested and must be subject to the same distribution restrictions that apply to 401(k) elective deferrals.

QNECs may be treated as elective deferrals in the ADP Test or as contributions in the ACP Test.

QNECs are generally allocated to only NHCEs to increase the NHCE ADP or NHCE ACP to a level where the applicable test(s) passes.

Note: *Qualified matching contributions* (QMACs) are similar to QNECs except they are allocated to only eligible employees who make elective deferrals.

QNECs and QMACs may be allocated in various ways but the allocation methodology used must be in the plan document.

QNEC Allocated as a Flat Percent of Compensation to All Eligible NHCEs

A	B	C	D	E=C/B	F	G=B*1.00%	H=C+G	I=H/B	J
Participant	2001 Compensation	2001 Elective Deferrals	2001 Employer Match*	ADR Actual Deferral Ratio	ADP	Allocate 1.00% QNEC to all NHCEs	Elective Deferrals for ADP Test	New ADR	New ADP
HCE Group					7.00%				7.00%
NHCE 1	60,000.00	3,000.00	1,500.00	5.00%		600.00	3,600.00	6.00%	
NHCE 2	50,000.00	5,000.00	1,500.00	10.00%		500.00	5,500.00	11.00%	
NHCE 3	40,000.00	0.00	0.00	0.00%		400.00	400.00	1.00%	
NHCE 4	30,000.00	1,800.00	900.00	6.00%		300.00	2,100.00	7.00%	
NHCE 5	20,000.00	0.00	0.00	0.00%		200.00	200.00	1.00%	
NHCE 6	15,000.00	450.00	225.00	3.00%		150.00	600.00	4.00%	
NHCE Group					4.00%	2,150.00			5.00%

HCE limit is 6.00%. Test ADP FAILS!

HCE limit is 7.00%. ADP Test PASSES!

Conclusion: Employer may correct the failed ADP Test by making a QNEC in the amount of \$2,150.00.

QMAC Allocated to All Eligible NHCEs who made Elective Deferrals

A	B	C	D	E=C/B	F	G	H=C+G	I=H/B	J
Participant	2001 Compensation	2001 Elective Deferrals	2001 Employer Match*	ADR Actual Deferral Ratio	ADP	QMAC of 28.5% of deferrals up to first 6% of comp	Elective Deferrals for ADP Test	New ADR	New ADP
HCE Group					7.00%				7.00%
NHCE 1	60,000.00	3,000.00	1,500.00	5.00%		1,026.00	4,026.00	6.71%	
NHCE 2	50,000.00	5,000.00	1,500.00	10.00%		855.00	5,855.00	11.71%	
NHCE 3	40,000.00	0.00	0.00	0.00%		0.00	0.00	0.00%	
NHCE 4	30,000.00	1,800.00	900.00	6.00%		513.00	2,313.00	7.71%	
NHCE 5	20,000.00	0.00	0.00	0.00%		0.00	0.00	0.00%	
NHCE 6	15,000.00	450.00	225.00	3.00%		128.25	578.25	3.86%	
NHCE Group					4.00%	2,522.25			5.00%

HCE limit is 6.00%. Test ADP FAILS!

HCE limit is 7.00%. ADP Test PASSES!

Conclusion: Employer may correct the failed ADP Test by making a QMAC in the amount of \$2,522.25 (\$372.25 more than the QNEC).

*Match Formula: 50% of elective deferrals up to first 6% of compensation (i.e. match limited to 3% of compensation)