Are You Passing the Average Deferral Percentage Test?

If you offer a 401(k) plan, you need to ensure it passes the annual nondiscrimination tests. If your plan fails, you may have to take corrective steps. Understanding how the Average Deferral Percentage test works can help you assess how well your plan is performing.

Understanding the average deferral percentage test

Most 401(k) plans need to pass the Average Deferral Percentage (ADP) test unless they qualify for certain exceptions. This test examines the average deferral rates of non-highly compensated employees compared to those of highly compensated employees.

Annual NHCE Contribution Rate	Maximum Annual HCE Contribution Rate
Less than 2%	NHCE% x 2
Between 2-8%	NHCE% + 2
More than 8%	NHCE% x 1.25

This comparison helps ensure participation and contributions are fair by setting limits based on the average deferral rates for both employee groups. If highly compensated employees put in much more than non-highly compensated employees, the plan could fail the test. If that happens, some contributions from highly compensated employees might have to be returned.

For example, if non-highly compensated employees have an average deferral rate of 3%, highly compensated employees are usually limited to 5%. If the average is 1%, the limit is usually 2%. Who fails, and why do they fail?

Why plans fail the ADP test

Plans often fail the test because of how employees participate, not because anyone did something on purpose.

Plans usually fail when non-highly compensated employees either do not join or put in very little. The test counts all eligible employees, even those who do not contribute, which can bring down the average deferral rate.

For example, if a company has ten non-highly compensated employees and only five put in 6% while the others put in nothing, the average deferral rate is 3%. This limits how much highly compensated employees can contribute.

With the right support, you can create a plan that benefits your employees and aligns with your business goals.

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In small companies, contributions from highly compensated employees can have a big impact on test results. One person with a high or low deferral rate can change the averages a lot.

For example, if a business owner's spouse earns a modest salary but puts in a large percentage, this can affect the results. Even a small total amount, if matched with a high deferral rate, can change the averages.

Why plan design matters

Knowing how the ADP test works can help you make better decisions. Choosing the right plan design can boost participation and lower the chance of problems in future tests.

Features like automatic enrollment and clear contribution rules can help more employees join and make test results more consistent. A signed plan can benefit employees at all income levels and support your business objectives.

Is your retirement plan working as intended?

A retirement plan is an important part of your overall pay strategy. If set up well, it helps employees save for retirement and supports your goals for keeping staff and managing costs. Many plans do not perform as intended. Some employees never enroll, while others wish to save more but are unaware of plan limits.

Reviewing your plan design options can help you see how it can benefit both your business and your employees.

Request a complimentary plan design consultation

Talk to experienced retirement plan specialists to determine whether your current plan design meets testing requirements and participation goals.

For more information, contact:

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