Top Heavy vs. ADP: What's the Difference?

Facts

As a plan sponsor, I do my best to review the annual compliance reports my TPA sends to me, but to be honest, it might as well be written in a foreign language. For example, several of our participants were recently required to receive corrective refunds due to contributing too much for 2018. I thought it was because our plan was top heavy last year, but then my TPA mentioned something called an ADP test.

Question

Key employees, highly compensated employees, top heavy determinations and ADP tests! Yikes! Can you help me make sense of all this?

Answer

It can seem as though retirement plan professionals speak their own language. Between the alphabet soup of acronyms, endless code section citations, and numerous tests that all seem to measure some type of discrimination – the whole conversation can get pretty confusing.

One topic that seems to be a regular source of confusion (due to this language barrier) is the difference between the top heavy determination and the ADP test. While both of these tests occur on an annual basis, the major similarities end there. What each one measures, and the ramifications of the results are widely different. When considering plan design options and strategies for avoiding failed testing, having a basic understanding of these two tests can add some needed clarity. Its justifiably hard to plan strategically if you don't know the rules of the game. To this end, we offer the translations below.

Key Employees vs. Highly Compensated Employees (HCEs)

Before diving into the specific tests, it is important to first understand the differences between these two groups of employees. Generally speaking, key employees are the owners and officers of the company. Anyone who owns more than 5% of the company is definitely a key employee. Officers and those who own 5% or less must also have gross annual compensation above certain levels to be considered key.

Those who own more than 5% are also highly compensated employees. In addition, anyone who had gross compensation from the company in excess of $120,000 during the immediately preceding year is an HCE. That dollar limit is indexed for inflation each year in $5,000 increments.

In smaller companies, it is pretty common for the groups of HCEs and key employees to be comprised of the exact same people. In larger companies, however, the two groups will not necessarily be the same.

Top Heavy Determination

The top heavy determination compares the percentage of total plan assets that belong to the key employees to the percentage held in the accounts of non-key employee. The magic number here is 60%. If the key employees hold more than 60% of the plan assets as of the plan year end, the plan is top heavy for the next plan year.

So, what does that mean, exactly? If a plan is top heavy, the company is required to make a minimum contribution on behalf of the non-key participants. Although there are some variations, the required contribution is usually 3% of each person's pay (offset dollar for dollar by any company contributions already made for that year).

ADP Test

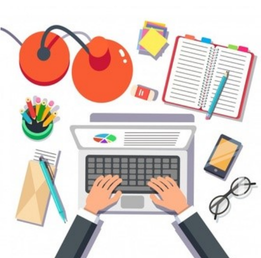
While the top heavy determination is based on accumulated plan assets, the actual deferral percentage (ADP) test is a snap shot of a single year's deferral rates. It compares the average amounts deferred by the HCEs (as a percentage of pay) to the average deferral rates of the non-HCEs. Again, there are some variations here, but the magic number is usually 2%. That is the maximum allowable spread between the groups. If the HCE average exceeds the NHCE average by more than two percentage points in a given year, the ADP test fails for that year. The ACP test generally works the same way except that it compares matching contributions.

Let's say the plan fails the ADP test, now what? In order to correct the failure, action must be taken to close the gap between the two groups. There are several options for doing so. The most common is for the plan to refund contributions to some or all of the HCEs (according to a specific method specified in the Tax Code) to reduce their average to the allowable level. Conversely, the company can also make additional contributions to the non-HCEs to increase their average. Sometimes, a combination of refunds and contributions is the best bet. All of these options are allowable. It is up to each company to decide in a given year which one makes the most sense, and the chosen method can vary from year to year.

Now that we've established the high-level differences between the top heavy determination and ADP test, we'll share a quick note about plan design. As you might guess, most companies prefer to avoid failing the ADP test or having their plans become top heavy. By adding what is called a safe harbor 401(k) provision, companies can agree up front to provide a minimum matching contribution (max of 4% of pay) to those who defer or profit sharing-type contribution (max of 3% of pay) to all eligible employees as a way to "buy" their way out of both of these tests. If you suspect that there must be more to it, you're right. But we'll save those details for another post!

Related Resources

- Nondiscrimination Testing Overview
- From the Archives: Key Employees
- From the Archives: ADP Testing



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