

## ADP/ACP Refunds for Highly Compensated Employees (HCEs)

You were determined to be considered a highly compensated employee (HCE) for the 2020 plan year; either because of the compensation you earned the previous year or because of ownership in the plan.

In order to ensure a 401(k) plan is not favoring owners or highly paid employees, the IRS requires certain nondiscrimination testing is performed. The Actual Deferral Percentage Test (ADP) measures the employee deferral contributions and the Actual Contribution Percentage Test (ACP) measures the employer matching contributions. ADP/ACP testing must be completed annually.

The ADP test counts elective deferrals (both pre-tax and Roth deferrals, but not catch-up contributions) of the HCEs and NHCEs. Dividing a participant's elective deferrals by the participant's compensation gives you that participant's contribution rate. Both tests take the *average* contribution rates of the Highly Compensated Employee (HCE) group of participants and compare to the *average* contribution rate of the Nonhighly Compensated Employee (NHCE) group of participants.

In order to pass the tests, the HCE average contributions (deferrals or match) must be within a certain percentage of the average contributions of the NHCEs (usually within 2%).

If the test fails, then corrective action is required to keep the plan qualified. Corrections for a failed test (ADP and/or ACP) failures are considered Excess Contributions and corrections are required per IRS rules.

As an HCE, you are receiving a refund because the testing failed and a correction must be made.

### IS THIS REFUND TAXABLE TO ME?

The refund is not eligible for favorable tax-free rollover. The refunded excess contribution is taxable to the HCE in the year of distribution. The HCE will receive a 1099-R the following January to report the taxable amount. By default, federal tax of 10% is withheld, however the participant may elect to have additional tax withheld.