CHAPTER 3-- CASH OR DEFERRED ARRANGEMENTS AFTER 1997 AND SELECTED EXAMINATION ISSUES

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I. INTRODUCTION

In a cash or deferred arrangement ("CODA"), an eligible employee may elect to receive an amount in cash (or some other taxable benefit if it is a nonqualified CODA) or to have the employer make payments as contributions to a plan for the employee's benefit. These contributions are "elective deferrals," but are often referred to as elective contributions ("ECs") when made to a CODA. They are treated as employer contributions for most purposes under the Internal Revenue Code. CODAs may be qualified, meaning they satisfy the requirements of section 401(k), or nonqualified.

This lesson focuses on qualified CODAs. The term "section 401(k) plan" is used in this lesson to denote a plan that contains a qualified CODA and that may or may not provide for other contributions, such as, matching, employee or nonelective contributions. A nondiscrimination test, known as the actual deferral percentage ("ADP") test, applies to ECs and certain other employer contributions that are treated as ECs. A nondiscrimination test, known as the actual contribution percentage ("ACP") test, applies to employee and matching contributions and certain other contributions that are treated as matching contributions.

The Small Business Job Protection Act of 1996 ("SBJPA") made significant changes affecting section 401(k) plans, particularly in regard to testing and correcting for discrimination. To a lesser extent, the Taxpayer Relief Act of 1997 ("TRA") and the Internal Revenue Service Restructuring and Reform Act of 1998 ("RRA") made changes affecting section 401(k) plans.

The purpose of this lesson is to summarize the changes made by SBJPA, TRA and RRA and to describe the new regime for testing and correcting for discrimination, rather than to provide a general overview of all the rules applicable to section 401(k) plans. Selected examination issues are also discussed. For a general discussion of section 401(k) plans, see the EP Phase I Course Book (May 1995), and the Examination Guidelines, IRM 7.7.1, keeping in mind that they have not (as of July 2000) been updated to reflect current law.

II. BACKGROUND

Many of the rules applicable to CODAs are set forth in IRC section 401(k) and Treas. Reg. section 1.401(k)-1. In addition, if a plan accepts employee or matching contributions, the plan must satisfy the requirements of IRC section 401(m) and Treas. Reg. section 1.401(m)-1. However, the regulations have not been updated to reflect changes made by SBJPA, TRA or RRA, so the Code and recently published guidance must be consulted in addition to the regulations.

The following guidance on section 401(k) plans has been published recently by the Service:

1. Notice 97-2, 1997-1 C.B. 348, dealing with the methodology of prior year testing and correction.

2. Rev. Proc. 97-9, 1997-1 C.B. 624, relating to SIMPLE 401(k) plans and providing a model amendment.

3. Notice 98-1, 1998-1 C.B. 327, providing guidance on prior year testing.

4. Notice 98-52, 1998-2 C.B. 632, and Notice 2000-3, 2000-4 I.R.B. 413, providing guidance on safe harbor plans.

5. Notice 99-5, 1999-3 I.R.B. 10, and Notice 2000-32, 2000-26 I.R.B. 1274, providing guidance on ineligible rollover distributions.

6. Rev. Rul. 2000-8, 2000-7 I.R.B. 617, dealing with automatic enrollment ("negative elections") features.

III. SUMMARY OF CHANGES AFFECTING SECTION 401(k) PLANS

A. Effective in 1997

(1) IRC section 401(k)(4)(B) was amended by section 1426(a) of SBJPA to permit tax exempt organizations and Indian tribal governments to maintain 401(k) plans.

(2) IRC section 401(k)(7) was amended by section 1443 of SBJPA to expand the definition of rural co-ops and permit (after August 20, 1996) certain distributions from 401(k) plans of such entities.

(3) IRC section 401(k)(11) and 401(m)(10) were added by section 1422 of SBJPA (as amended by section 1601(d) of TRA) to permit SIMPLE section 401(k) plans.

(4) IRC section 401(k) and 401(m) were amended by section 1433(c), (d) and (e) of SBJPA to allow testing HCEs' ADP and ACP against prior year's NHCEs' ADP and ACP and to change the method of correcting failed tests.

(5) IRC section 401(k)(3)(G) was added by section 1505(b) of TRA to provide that governmental plans are treated as satisfying the ADP test.

(6) IRC section 414(q) was amended by section 1431 of SBJPA to repeal the family aggregation rules and simplify the definition of HCE.

B. Effective in 1998

(1) IRC section 401(k)(7) was amended by section 1525 of TRA to permit certain mutual irrigation and drainage companies to maintain section 401(k) plans.

(2) IRC section 402(g)(9) was added by section 1501 of TRA to provide that matching contributions for self-employed individuals are not to be treated as elective deferrals.

(3) IRC section 415(c)(3) was amended by section 1434 of SBJPA to provide that the definition of compensation includes elective deferrals and deferrals made under section 125 and section 457 plans.

C. Effective in 1999

(1) IRC section 401(k)(12) and 401(m)(11) were added by section 1433(a) and (b) of SBJPA to provide safe-harbor methods for satisfying the nondiscrimination tests of section 401(k) and 401(m).

(2) IRC section 401(k)(3)(F) and 401(m)(5)(C) were added by section 1459 of SBJPA to permit the ADP and ACP tests to be applied by excluding NHCEs who have not met the minimum age and service requirements of section 410 in certain cases.

(3) IRC section 402(c)(4) was amended by section 6005(c)(2)(A) of RRA to provide that a hardship distribution of elective deferrals is not eligible for rollover.

D. USERRA

In addition to the above, the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353 ("USERRA"), codified at 38 U.S.C. section 4301-4333, revised and restated the Federal law protecting the reemployment rights of an employee following an absence because of military service. Among the protected rights is the right to receive certain pension, profit-sharing and similar benefits that would have been received but for the employee's absence during military service. (See section 414(u), added to the Code by section 1704(n) of SBJPA.) For a summary of the requirements of USERRA and section 414(u), see Rev. Proc. 96-49, 1996-2 CB 369.

IV. PRIOR YEAR TESTING

A. General description of ADP test and ACP test

The exclusive nondiscrimination test for amounts contributed under a qualified CODA is the ADP test set forth in section 401(k)(3). This test compares the amounts contributed by eligible highly compensated employees ("HCEs") as a percentage of compensation with the amounts contributed by eligible nonhighly compensated employees ("NHCEs") as a percentage of compensation. The average of these percentages for HCEs (the "HCE ADP") must satisfy either of the following tests:

(1) the HCE ADP does not exceed the average of the percentages for NHCEs (the "NHCE ADP") times 1.25, or

(2) the HCE ADP does not exceed the lesser of

(i) 2 plus the NHCE ADP or

(ii) 2 times the NHCE ADP.

For plan years beginning **before** January 1, 1997, the HCE ADP was compared to the NHCE ADP for the same year (the testing year). This methodology is known as "current year" testing.

Section 1433(c) of SBJPA amended section 401(k)(3)(A) (and section 401(m)(2)(A), for the ACP test) so that, for plan years beginning after December 31, 1996, unless the employer elects to use current year testing, the HCE ADP (and ACP, if applicable) for a testing year is compared to the NHCE ADP (and ACP) for the prior year. This methodology is known as "prior year" testing.

Before performing the ADP test, the employer must determine the actual deferral ratio ("ADR") for each employee. The **ADR** is the employee's ECs, QNECs and QMACs divided by compensation. Similarly, for the ACP test, the actual contribution ratio **("ACR")** is the employee's after-tax and matching contributions (and in certain cases, ECs, QNECs and QMACs) divided by compensation.

The ADP is the average of the ADRs for the group, either HCE or NHCE, and the ACP is the average of the ACRs for the group.

Prior to this SBJPA change, an employer would not know how much eligible HCEs could defer until data for the NHCEs for the year was available, which was usually several months after the end of the year. Using prior year testing simplifies plan administration because an employer can determine the percentage of ECs and matching contributions that can be made on behalf of HCEs early in the plan year and have more time to plan for correction.

A failed ADP test (and ACP test) can be corrected by distributing excess contributions (or excess aggregate contributions in the case of the ACP test) from plan accounts of HCEs or by contributing QNECs or QMACs to the plan accounts of NHCEs.

An employer is subject to a 10-percent excise tax under section 4979 if correction by distribution does not occur by 2 ? months after the end of the testing year. If failed ADP (and ACP) tests

are not corrected by 12 months after the end of the testing year, the CODA (or plan, in the case of failed ACP tests) is not qualified.

Example 1:

Employer X maintains a plan containing a qualified CODA that provides that distribution of excess contributions is the only method under the plan to correct ADP test failures. The plan has a calendar-year plan year and both HCEs and NHCEs make ECs to the plan. In January 1997, Employer X determines that the plan fails the ADP test for 1996, and that a corrective distribution of excess contributions must be made to appropriate HCEs by March 15, 1997, to avoid all penalties.

Example 2:

Same facts as in Example 1, except that the testing year is 1997 and the plan is using the prior year testing method. The ADP for the NHCEs for 1996 under the plan can be determined early in 1997 by Employer X because it has obtained the necessary data on prior year NHCE status, contributions and compensation by January 1997. This simplifies plan administration for Employer X.

The individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individual's status in the current year. A special rule applies for the first plan year.

In the case of the first plan year of any plan (other than a successor plan), the amount taken into account as the ADP or ACP for NHCEs for the preceding plan year is **deemed** to be 3 percent, unless an election is made to use the actual ADP and ACP data for the first plan year.

Example 3:

Employee A was employed by Employer X and was an NHCE in Year One. Employee A no longer works for Employer X in Year Two.

For purposes of determining the prior year's ADP for Employer X's section 401(k) plan for the Year Two testing year, Employee A **is** taken into account. The result

would be the same if Employee A were still employed by Employer X but had become a HCE in Year Two.

Notice 97-2 and Notice 98-1 provide guidance on the use of the prior year method and the current year testing method and on changing from one method to the other. In general, Notice 98-1 requires that a plan must specify which of the two testing methods it is using. If the testing method is changed, the plan must be amended to reflect the change. See section IX of Notice 98-1.

B. Use of QNECs and QMACs in prior year testing

Under IRC section 401(k)(3)(D), an employer may take into account QNECs and QMACs in calculating the ADP, and under section 401(m)(3), an employer may take into account QNECs in calculating the ACP. (See EP Phase I Course Book (May 1995), pp. 14a-22, et seq., and 14b-3, et seq.) This continues to be permissible in a plan using prior year testing, subject to certain limitations.

To be taken into account for the ADP or ACP for the prior year, a QNEC or QMAC must be allocated as of a date within that prior year, and must actually be paid to the trust by the end of the 12-month period following the end of that prior year.

In other words, it must actually be paid to the trust by the end of the testing year; thus, when using prior year testing, an employer cannot use QNECs or QMACs to correct a failed ADP or ACP test because the employer won't know until after the testing year whether or not the ADP or ACP test is failed and by then the deadline for making corrective QNECs and QMACs has passed. Of course QNECs and QMACs made prior to the deadline can be counted.

EXAMPLE 4:

A plan uses the prior year testing method for the 1999 testing year. QMACs that are allocated to NHCEs' accounts as of the last day of the 1998 plan year may be taken into account in calculating the ADP only if those QMACs are actually contributed to the plan by the last day of the 1999 plan year.

Note that this does not change the rule under Code section 415, that employer contributions shall not be deemed credited to a participant's account for a particular limitation year unless the contributions are actually made no later than 30 days after the end of the section 404(a)(6) period applicable to the taxable year with or within which the particular limitation year ends. See Regs. section 1.415-6(b)(7)(ii).

Note also that this does not change the requirements under section 1.401(k)-1(b)(5) and 1.401(m)-1(b)(5), that

(i) the amount of nonelective contributions, including QNECs treated as ECs for the ADP test,

(ii) the amount of nonelective contributions, excluding QNECs treated as ECs for the ADP test,

(iii) the amount of nonelective contributions, including QNECs treated as matching contributions for the ACP test, and

(iv) the amount of nonelective contributions, excluding QNECs treated as matching contributions for the ACP test, must each satisfy section 401(a)(4) for the plan year for which they are allocated to participants' accounts.

C. First year rule for prior year testing

For the first plan year of a plan (other than a "successor plan," see below) that uses prior year testing, the ADP for NHCEs for the prior year is deemed to be 3%. See section 401(k)(3)(E).

Alternatively, if the employer so elects in the plan document, the NHCE ADP is equal to the NHCE ADP for that first plan year (i.e., the current year).

For ADP testing purposes, the "first plan year" is the first year in which the plan provides for elective deferrals. A plan does not have a first plan year if for that year it is aggregated under section 1.401(k)-1(g)(11) with any other plan that provided for elective deferrals in the prior year.

Similarly, for the first plan year of a plan (other than a "successor plan," see below) that uses prior year testing, the ACP for NHCEs for the prior year is deemed to be 3%. See section 401(m)(3).

> Alternatively, if the employer so elects in the plan document, the NHCE ACP is equal to the NHCE ACP for that first plan year (i.e., the current year).

For ACP testing purposes, the "first plan year" is the first year in which the plan provides for employee contributions, matching contributions or both. A plan does not have a first plan year if for that year it is aggregated under section 1.401(m)-1(f)(14) with any other plan that provided for employee contributions, matching contributions or both in the prior year.

A plan is a "successor plan" if 50% or more of the eligible employees for the first plan year were eligible employees under another CODA (or another plan that allowed employee or matching contributions) maintained by the employer in the prior year.

D. Changes in the group of NHCEs in prior year testing

In general, under the prior year testing method, subsequent changes in the group of NHCEs are disregarded. That is, the ADP or ACP for NHCEs for the prior year is determined with respect to eligible employees:

> who were NHCEs in that prior year, and
>
> without regard to changes in the group of eligible NHCEs in the testing year.

This is true even though some NHCEs in the prior year have become HCEs in the testing year, or are no longer eligible employees under the plan. It is also true even though some NHCEs in the testing year were not eligible employees in the prior year.

However, if a plan results from or is affected by a "plan coverage change" that becomes effective during the testing year then the NHCE ADP for the prior year is the weighted average of the ADPs for the prior year subgroups, and the NHCE ACP for the prior year is the weighted average of the ACPs for the prior year subgroups.

A "plan coverage change" is a change in the group(s) of eligible employees on account of:

(1) the establishment or amendment of a plan;

(2) a plan merger, consolidation, or spin-off under section 414(l);

(3) a change in the way plans are (or are not) permissively aggregated under section 1.410(b)-7(d); or

(4) any combination of the above.

A "prior year subgroup" is all NHCEs for the prior year:

who were eligible employees under a specific CODA (or a plan that allowed employee or matching contributions) maintained by the employer, and

who would have been eligible employees under the plan being tested if the plan coverage change had been effective as of the first day of the prior year.

The "weighted average of the ADPs (ACPs) for the prior year subgroups" is the sum, for all prior year subgroups of the "adjusted ADPs (ACPs)."

The "adjusted ADP (ACP)" for each prior year subgroup is the ADP (ACP) for the prior year for all NHCEs of the specific plan under which the members of the prior year subgroup were eligible employees, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup, and the denominator of which is the total number of NHCEs in all prior year subgroups.

Notice 98-1 contains examples involving plan coverage changes.

An exception to the exception: If there is a plan coverage change, and 90% or

more of all NHCEs from all prior year subgroups are from a single prior year subgroup, then the employer may elect to use the prior year ADP (ACP) for NHCEs of the plan that included that single prior year subgroup.

E. Changing testing method

A plan that uses the prior year testing method may adopt the current year testing method for any subsequent testing year. Notification to or prior approval of the Service is not required for the election to be valid. However, the employer may wish to apply for a determination letter on the plan amendment needed to implement the change.

A plan that uses current year testing after the 1997 plan year (see Notice 97-2) is permitted to change to prior year testing in four situations only:

1. The plan is not the result of the aggregation of two or more plans, and current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years the plan has been in existence).

2. The plan is the result of the aggregation of two or more plans, and for each of the aggregated plans current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years the plan has been in existence).

3. A transaction occurs that is described in section 410(b)(6)(C)(i) (i.e., the employer becomes or ceases to be a member of a section 414(b), (c), (m) or (o) group), and, as a result, the employer maintains both a plan using prior year testing and a plan using current year testing, and the change occurs within the transition period described in section 410(b)(6)(C)(ii) (i.e., by the last day of the 1st plan year beginning after the transaction).

4. The change occurs within the plan's SBJPA remedial amendment period (generally, the last day of the first plan year beginning on or after January 1, 2001; see Rev. Proc. 2000-27, 2000-26 I.R.B. 1272).

Notification to or prior approval of the Service is not required for the change to be valid. However, the employer may wish to apply for a determination letter on the

plan amendment needed to implement the change.

F. Limits on double counting of certain contributions

When a plan changes from current year testing to prior year testing, contributions on behalf of many, if not all, NHCEs are likely to be double counted.

> For example, if a plan used current year testing in 1998, and then changed to prior year testing in 1999, ECs on behalf of NHCEs for 1998 will be counted twice; once in 1998 in calculating the NHCE ADP under the current year testing method, and again in 1999 in calculating the NHCE ADP under the prior year testing method.

The following rules, set forth in Notice 98-1, serve to limit double counting:

1. The ADP for NHCEs for the prior year is determined taking into account only:

   a. ECs for NHCEs that were taken into account for purposes of the ADP test (and not the ACP test) under the current year testing method in the prior year; and

   b. QNECs that were allocated to NHCEs' accounts for the prior year, but that were not used to satisfy either the ADP test or the ACP test under the current year testing method for the prior year.

   Thus, the following contributions made for the prior year are disregarded for the ADP test:

   a. QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year,

   b. elective contributions taken into account for purposes of the ACP test, and

   c. all QMACs.

2. The ACP for NHCEs for the prior year is determined taking into account only:

a. employee contributions for those NHCEs for the prior year;

b. matching contributions for NHCEs that were taken into account for purposes of the ACP test (and not the ADP test) under the current year testing method in the prior year; and

c. QNECs that were allocated to NHCEs' accounts for the prior year, but that were not used to satisfy either the ADP test or the ACP test under the current year testing method for the prior year.

Thus, the following contributions made for the prior year are disregarded for the ACP test:

1. QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year,

2. QMACs taken into account for purposes of the ADP test, and

3. all elective contributions.

These limitations on double counting do not apply for testing years beginning before January 1, 1999.

Thus, for a plan that changes to prior year testing for the first time for the 1998 plan year, the ADP and ACP for NHCEs will be the same as for the 1997 plan year. See Notice 98-1 for examples involving double counting.

G. Plan provisions regarding testing method

A plan must specify which of the two testing methods (current year or prior year) it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change.

The regulations under section 401(k) and (m) permit a plan to incorporate by reference section 401(k)(3) and (m)(2) (and, if applicable, (m)(9)) and the underlying regulations. A plan that incorporates these provisions by reference may continue to do so, but must specify which of the two testing methods

(current year or prior year) it is using. Further, for purposes of the first plan year rule, a plan that incorporates these provisions by reference must specify whether the ADP/ACP for NHCEs is 3% or the current year's ADP/ACP.

Rev. Proc. 2000-27 extends the remedial amendment period for SBJPA generally to the last day of the first plan year beginning on or after January 1, 2001. Any plan amendments to reflect a choice in testing method are not required to be adopted before the end of this remedial amendment period.

However, plans must be operated in accordance with the SBJPA changes as of the statutory effective date (section 1433(c) and (d), which added the prior year testing method, were effective for plan years beginning after December 31, 1996).

In addition, any retroactive amendments must reflect the choices made in the operation of the plan for each testing year, including the choice of testing method (and any changes to that method), and must reflect the date(s) on which the plan began to operate in accordance with those choices (and any changes).

V. DISTRIBUTION OF EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS

A failed ADP (or ACP) test can be corrected by distributing excess contributions (or excess aggregate contributions), adjusted for earnings, to certain HCEs by no later than 12 months after the close of the testing year, regardless of whether the plan is using the prior year or current year testing method.

"Excess contributions" are the amount of contributions used to calculate the HCE ADP that exceeds the amount of such contributions permitted if the ADP test were passed.

Similarly, "excess aggregate contributions" are the amount of contributions used to calculate the HCE ACP that exceeds the amount of such contributions permitted if the ACP test were passed.

The amount of excess contributions (or excess aggregate contributions) is determined using a leveling method based on HCEs' ADRs (or ACRs), beginning with the HCE with the highest percentage and continuing in descending order of ADR (or ACR) percentages until the target HCE ADP (or ACP) is reached.

EXAMPLE 5:

There are three HCEs in a section 401(k) plan:

HCE1 has compensation of $80,000 and ECs of $8,800 for an ADR of 11%;

HCE2 has compensation of $100,000 and ECs of $9,000 for an ADR of 9%; and

HCE3 has compensation of $150,000 and ECs of $10,500 for an ADR of 7%. The HCE ADP is 9%.

If the HCE ADP needs to be 8% to pass the ADP test, the amount of excess contributions is determined by multiplying one or more HCE's compensation by the percentage that such HCE's ADR would have to be reduced, using the percentage leveling method, in order to produce a HCE ADP of 8%.

The highest ADR percentage, HCE1's 11%, is reduced to the next highest, HCE2's 9%, and then both HCE1 and HCE2's reduced ADRs are further reduced to 8.5%, so that the HCE ADP using these reduced ADRs is 8%.

HCE1's ADR reduction by 2.5% produces excess contributions of $2,000 (2.5% x $80,000) and

HCE2's ADR reduction by 0.5% produces excess contributions of $500 (0.5% x $100,000) for a total amount of excess contributions of $2,500.

For plan years beginning **before** January 1, 1997, corrective distributions of excess contributions (and excess aggregate contributions), adjusted for earnings, were made to the HCEs whose ADRs were used to determine the amount of excess contributions (or excess aggregate contributions) and in the same amount.

So in Example 5 above, $2,000 (adjusted for earnings) would be distributed to HCE1 and $500 (adjusted for earnings) to HCE2.

Section 1433(e) of SBJPA amended IRC section 401(k)(8)(C) and 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that corrective distributions are made based on HCEs' dollar amount of contributions

rather than on their percentages.

In other words, excess contributions (and excess aggregate contributions) are distributed to HCEs who have the largest amount of contributions in the numerator of their ADR (or ACR) (a dollar leveling method).

The method of determining the amount of excess contributions (and excess aggregate contributions) remains the same. Thus the HCEs whose ADRs are used to calculate the excess amount may be different from the HCEs who receive a corrective distribution.

So in Example 5 above, the $2,500 of excess contributions would be allocated $1,900 to HCE3 (the HCE with the largest amount of ECs), $400 to HCE2 (the HCE with the next largest amount of ECs) and $200 to HCE1.

Note that if these distributions are made, the section 401(k) plan is treated as meeting the ADP test even though the HCE ADP, if recalculated after distributions, would not satisfy the ADP test.

A parallel method is used for the purpose of recharacterizing excess contributions under section 401(k)(8)(A)(ii).

Notice 97-2 provides that after excess contributions and excess aggregate contributions, if any, have been distributed using the method described above, the multiple use test of section 401(m)(9) is applied. For purposes of section 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for HCEs is deemed to be the largest amount permitted under section 401(k)(3). Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under section 401(m)(2).

See Notice 97-2 for an example involving corrective distributions.

VI. COMPREHENSIVE EXAMPLE

A plan has 3 HCEs and a fully vested matching contribution equal to the participant's deferrals that do not exceed 5% of compensation.

Table I-Basic Data

	Compensation	Deferrals	ADR	Match	ACR
HCE1	$150,000	$6,000	4%	$6,000	4%
HCE2	$120,000	$6,000	5%	$6,000	5%
HCE3	$80,000	$4,800	6%	$4,000	5%

	ADP	*ACP*
HCE	5%	4.67%
NHCE	2.5%	2%

To correct ADP (HCE ADP cannot exceed 4.5%) by distributing excess contributions:

STEP 1 - determine amount of excess and assign deemed ADRs to HCEs

To get HCE ADP to **4.5%,** reduce the ADR of HCE2 and HCE3 to 4.75%, which produces an excess of $300 for HCE2 and $1,000 for HCE3, for a total of $1,300.

STEP 2 - assign the excess to HCEs with largest deferrals

The $1,300 is split evenly between HCE1 and HCE2 (because they have the same amount of deferrals), leaving them with $5,350 each in deferrals:

	REMAINING DEFERRALS	DEEMED ADR
HCE1	$5,350	4%
HCE2	$5,350	4.75%
HCE3	$4,800	4.75%

HCE **deemed ADP** = 4.5%

To correct ACP (HCE ACP cannot exceed 4%) by distributing excess aggregate contributions:

STEP 3 - determine amount of excess and assign deemed ACRs to HCEs

To get HCE ACP to 4%, reduce the ACR of HCE2 and HCE3 to 4%, which produces an excess of $1,200 for HCE2 and $800 for HCE3, for a total of $2,000.

STEP 4 - assign the excess to HCEs with largest matches

The $2,000 is split evenly between HCE1 and HCE2, leaving them with $5,000 each in matching contributions:

	Remaining Matches	Deemed ACR
HCE1	$5,000	4%
HCE2	$5,000	4%
HCE3	$4,000	4%

HCE deemed ACP = 4%

If the multiple use test fails (it does, since the sum of the HCE ADP and ACP exceeds the maximum permitted amount), go on to STEP 5. Correction under the plan is by distribution of excess aggregate contributions.

STEP 5-use deemed HCE ADP and ACP, determine maximum sum permitted and repeat STEPs 3 and 4.

Sum of HCE ADP and ACP is 8.5%; maximum permitted is 7.13% ((2 + 2%) + (1.25 x 2.5%)).

Need to reduce HCE ACP to 2.63% (by reducing all HCE ACRs to 2.63%) so that the sum of the HCE ADP (4.5%) and ACP equals 7.13%. This would produce an excess of $2,055 for HCE1 ($150,000 x 1.37%), $1,644 for HCE2 ($120,000 x 1.37%) and $1,096 for HCE3 ($80,000 x 1.37%), for a total of $4,795. This would be assigned $1,932 to be distributed from both HCE1 and HCE2 and $932 from HCE3, leaving all three HCEs with matching contributions of $3,068 each.

VII. MISCELLANEOUS EXAMINATION ISSUES AND AUDIT TIPS

While the changes made by SBJPA, TRA and RRA are significant, there are also ongoing examination issues that occur under the general rules applicable to CODAs. Some of these issues are discussed below.

A. Age and service requirements

A qualified CODA may not require an employee to complete a period of service

with the employer beyond the period permitted under IRC section 410(a)(1), which is the later of when the employee reaches age 21 or completes one year of service. The special rule under section 410(a)(1)(B) under which plans provide for 100% vesting after 2 years of service is not applicable to qualified CODAs.

EXAMINATION STEP:

Confirm that the employer has not erroneously required a 2-year eligibility period before an employee can make ECs.

B. Coverage and participation

The CODA portion of the plan, by itself, must satisfy one of the coverage tests set forth in IRC section 410(b), either the ratio percentage test or the average benefits test. To satisfy the ratio percentage test, a CODA may be aggregated with another CODA (if it has the same plan year and uses the same testing method) but may not be aggregated with any non-CODA.

In determining whether the coverage tests have been satisfied, there is a special section 401(k) coverage rule for qualified CODAs. Under this rule, the CODA counts each person who is eligible to make an EC as benefiting, regardless of whether the employee actually elected to make deferrals. (Note that a nonqualified CODA may not use this special benefiting rule.)

For all non-CODA plans of an employer, in determining an employee's employee benefit percentage for the average benefits percentage test under IRC section 410(b), Treas. Reg. section1.410(b)-5(d)(3)(i) and 1.410(b)-7(e) require that section 401(k) and 401(m) plans (except for the after-tax, employee contributions in a section 401(m) plan) and ESOPs be taken into account.

EXAMINATION STEP:

Determine that the section 401(k) and section 401(m) contributions are included in the average benefits portion of the general test.

C. Disregarding employees

In general, a qualified plan may prohibit employees from entering the plan prior to the attainment of age 21 and the completion of one year of service (see section 410(a)). An employer that allows employees to enter the plan earlier (e.g., age 18) may choose separate testing under which all employees who have not met the statutory age and service entry maximums are disregarded, provided that:

> the plan satisfies the nondiscrimination rules taking into account only those covered employees whose age and service are less than the statutory age and service maximums.

In other words, it's as if the employer had two plans,

> **one** containing covered employees who satisfy the maximum age and service requirements under section 410(a) and
>
> **one** containing covered employees who don't.

Section 1459 of SBJPA added section 401(k)(3)(F) and section 401(m)(5)(C) to the Code to provide a special rule for early participation. Congress believed that some employers were reluctant to include younger or new employees in a section 401(k) plan because these employees tended to have lower deferral percentages and therefore could cause the plan to fail the ADP (and ACP) test.

To encourage coverage of these employees, **effective for plan years beginning after December 31, 1998**, an employer may elect to disregard employees (other than HCEs) eligible to participate in the plan before they have completed one year of service and reached age 21, provided:

> the plan separately satisfies the minimum coverage rules of section 410(b) taking into account only those employees who have not completed one year of service or are under age 21.

A single ADP test is applied that compares the ADP for all eligible HCEs with the ADP for eligible NHCEs who have completed one year of service and reached age 21. A similar rule applies for purposes of the ACP test.

D. Definition of a CODA

Any plan that allows a participant to make a cash or deferred election has a

CODA. Only a profit-sharing, stock bonus, pre-ERISA money purchase pension plan or a rural cooperative plan may contain a CODA. A cash or deferred election is an election by an employee to have the employer either

(1) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available (only cash for a qualified CODA) or

(2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

If there is such an election, then the plan contains a CODA, even if an employer does not intend to offer one. This could have serious consequences since a plan that is not permitted to contain a CODA is disqualified.

EXAMPLE 6:

Employer X maintains Plan A, a defined benefit plan. Employees may waive out of participation every year. Employer X increases the compensation of employees that waive out of the plan. Plan A contains a CODA. Since defined benefit plans may not offer CODAs, Plan A is disqualified.

An exception exists for a one-time irrevocable election made by an employee when the employee is first hired or first eligible under one of the employer's plans. Although any choice between cash and a deferral is technically a CODA, Treas. Reg. section1.401(k)-1(a)(3)(iv) provides an exception. (See also Treas. Reg. section 1.402(g)-1(c).) A one-time irrevocable election by the employee when first hired or first eligible for any plan of the employer, is deemed not to be a choice between cash and a deferral and therefore does not create a CODA. Once such an election is made, it cannot be changed. In addition, a change in status, such as from associate to partner or union employee to supervisor does not give rise to another one-time irrevocable election. Once an employee has participated in any plan of the employer, the one time election is unavailable.

EXAMPLE 7:

Employer X terminated Plan Y, a money purchase plan. Employer X replaced Plan Y with Plan Z, another money purchase plan. Employee A elected to receive a 5% contribution under the old plan. Employee A may only receive a 5% contribution under the new plan.

E. Top heavy rules

Every employer maintaining a qualified plan (other than a SIMPLE 401(k) plan) must satisfy the top-heavy requirements of section 416. If an employer maintains only a plan containing a CODA, the required top heavy minimum contributions must be satisfied in that plan for any year the plan is top heavy. If there are other plans, the employer may (but is not required to) satisfy the minimum contribution requirements in another plan instead of the CODA.

Elective Contributions (EC)s and matching contributions made on behalf of key employees are taken into account for purposes of determining the minimum contribution requirement under section 416. However, ECs and matching contributions used in the ACP test, may not be used to satisfy the minimum contribution requirements under section 416. See Treas. Reg. section 1.416-l (M-19 and 20).

QNECs, however, whether or not used to satisfy the ADP or ACP test, can also be used to satisfy the required minimum contribution under section 416. See section 1.416-l (M-18). If any key employee has an overall allocation of at least 3 percent of compensation, all eligible nonkey employees must receive an employer contribution of at least 3 percent of compensation. If the highest contribution on behalf of any key employee is less than 3 percent of compensation, the nonkey employees should receive a percentage of compensation **equal** to the percentage of compensation paid to the key employee receiving the highest percentage of compensation under the plan for the year.

EXAMPLE 8:

Employer X maintains a plan with a CODA that does not provide for matching contributions or QNECs. Key employee A is the only key employee in the plan.

Key employee A has received an EC allocation of 2.3% of compensation. Nonkey employee B has received an EC allocation of 2.0%. Employer X must make a minimum contribution under section 416 of 2.3% to the account of Employee B (in addition to the 2.0% EC).

Any amounts used to satisfy the minimum contribution requirements may not be counted as a matching contribution. See Treas. Reg. section 1.401(m)-

1(f)(12)(iii). These amounts must be tested under the nondiscrimination requirements of IRC section 401(a)(4) without regard to section 401(m).

Note: SIMPLE 401(k) plans are not subject to the top heavy rules.

EXAMINATION STEPS:

1. Determine that the employer has properly provided a minimum top heavy contribution in addition to ECs for nonkey employees.

2. Determine that the employer has not included "matching contributions" used to satisfy the top heavy minimum contribution for nonkey employees in the ACP or ADP tests. Such "matching contributions" must be tested under the section 401(a)(4) general rules.

F. Discrimination

When employers timely reduce an HCE's ADR in order to satisfy the ADP test, they sometimes do not make the corresponding reduction to the match. This may create a discriminatory match and a failure to follow the terms of the plan if the plan calls for the match to be reduced.

When employers recharacterize section 401(k) contributions as after-tax employee contributions in order to satisfy the ADP test, they sometimes forget to include the amounts in the ACP test, which may result in a section 401(m) failure. Both of these situations may be corrected upon examination through the Closing Agreement Program.

EXAMINATION STEPS:

1. Determine that the employer has reduced matching contributions, if necessary, as well as deferrals under the ADP test.

2. Determine that the employer has included recharacterized contributions in the ACP test.

G. Loans

Under IRC section 72(p) a loan from a qualified plan is treated as a taxable distribution to the participant, unless the requirements listed in section 72(p) are met, including limits on amounts and requirements on repayment periods and level amortization periods. If these are not met, all or part of the loan may be deemed a taxable distribution under section 72(p).

Treas. Reg. Section 1.401(k)-1(d)(6)(ii) provides that the making of a loan under a CODA is not treated as a distribution for purposes of plan qualification even if the loan is secured by the employee's accrued benefit attributable to ECs or the loan is includible in the employee's income under section 72(p). However, if an employee's accrued benefit derived from ECs is reduced by reason of default on a loan then the reduction is treated as a distribution.

H. IRC section 4979 Tax

Under IRC section 4979 the employer is liable for an excise tax equal to 10 percent of any excess contributions or excess aggregate contributions that are not corrected within 2-1/2 months after the end of the plan year being tested.

However, the tax is not applied if QNECs or QMACs were added within 12 months after the end of the plan year being tested.

If the QNECs or QMACs added were insufficient to fully satisfy the ADP test, the tax will apply to the remaining excess contributions.

The IRC section 4979 tax is paid by the employer, and is due 15 months after the end of the plan year being tested. See Treas. Reg. section 54.4979-1. The extension of the time to pay the tax is not an extension of the time to correct the plan. The tax is reported on Form 5330. Thus, if the ADP test is failed for the 1999 calendar plan year, and correction is not made, or is made by distributions after March 15, 2000, the employer must file a Form 5330 and pay the excise tax by March 31, 2001.

Only apply this excise tax one time per qualified CODA failure. The fact that the CODA remains nonqualified for more than one year does not make the excise tax apply to the second year.

Of course, if the employer simply makes corrective distributions after the March 15 deadline, and does the same thing next year, the excise tax does apply next year.

EXAMINATION STEP:

Consider the excise tax when a plan has excess contributions or excess aggregate contributions that have not been timely corrected.

I. Multiple use of the alternative limitation

Multiple use occurs where an employer maintains a CODA and a plan subject to section 401(m) and both the ADP and ACP tests of that employer's plans can only be satisfied using the "**2 times/ 2 plus" prong** (the alternative limitation) of those tests. See section 401(k)(3)(A)(ii)(II) and section 401(m)(2)(A)(ii). Section 401(m)(9) and Treas. Reg. Section 1.401(m)-2 set forth rules that prevent the multiple use of the alternative limitation for HCEs.

EXAMINATION STEP:

Consider the multiple use test when one or more HCEs of the employer are eligible employees in both a CODA and a plan subject to section 401(m).

J. Discrepancy adjustments

If the statute of limitations is closed on a Form 1040, the amount of HCE deferrals that should have been included in income when the ADP test is failed, may not be included in a later year.

If a discrepancy adjustment is made to a HCE's 1040 and the plan is requalified through the Closing Agreement Program, the employee will have basis in the amount taxed through the discrepancy adjustment, so upon ultimate distribution it will not be taxed again. See IRM 7.7.1, Chapter 12.3.

K. Revenue Ruling 96-47

Under Rev. Rul. 96-47, 1996-2 C.B. 35, a profit-sharing plan allowed participants who had not terminated employment to direct investments of their accounts. Terminated participants could not direct their investments. The plan provided that a participant who terminated employment prior to the normal retirement date would receive his or her vested account balance at normal retirement date unless the participant elected to

receive an immediate distribution of the vested account balance.

IRC section 411(a)(11) requires the participant's consent before benefits are distributed. Treas. Reg. section 1.411(a)-11(c)(2)(i) provides that consent is not valid if a significant detriment is imposed on participants that do not consent to the distribution. The revenue ruling concluded that under the facts, the loss of the right to direct investments is a significant detriment, and a violation of section 411(a)(11) had occurred.

EXAMINATION STEP:

If a CODA places significant restrictions on a participant's right to direct investments after the participant has received a distribution you should consider whether a violation of section 411(a)(11) has occurred. See Rev. Rul. 96-47.

VIII. PUBLISHED GUIDANCE

Notice 97-2

This notice provides guidance and transition relief relating to the revised nondiscrimination rules under section 401(k) and section 401(m) of the Internal Revenue Code. The rules applicable to qualified cash or deferred arrangements under section 401(k) and matching and employee contributions under section 401(m) were changed by the Small Business Job Protection Act of 1996 (SBJPA), Pub. L. 104-188.

Under section 401(k) and section 401(m) of the Code, the actual deferral percentage (ADP) and the actual contribution percentage (ACP) of highly compensated employees (HCEs) are compared with those of nonhighly compensated employees (NHCEs).

Section 1433(c) of the SBJPA amends section 401(k)(3)(A) and section 401(m)(2)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP of NHCEs, while current year data is used for HCEs.

Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but

this election may only be changed as provided by the Secretary. Prior to the effective date of these amendments, plans must use current year data in determining the ADP and ACP for both HCEs and NHCEs.

Section 1433(e) of the SBJPA amends section 401(k)(8)(C) and section 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that the distribution of excess contributions and excess aggregate contributions will be made on the basis of the amount of contributions by, or on behalf of, each HCE.

Prior to the effective date of these amendments, plans must distribute excess contributions and excess aggregate contributions using a method based on the actual deferral ratio or actual contribution ratio of each HCE.

This notice provides guidance regarding:

the determination of the ADP and ACP for NHCEs under section 401(k)(3)(A)(ii) and section 401(m)(2)(A) for plan years beginning after December 31, 1996,

transition relief for plans that elect to use current year ADP or ACP data for the 1997 plan year, and

guidance regarding the distribution of excess contributions and excess aggregate contributions under section 401(k)(8)(C) and section 401(m)(6)(C) for plan years beginning after December 31, 1996.

I. DETERMINATION OF ADP AND ACP FOR NHCEs USING PRIOR YEAR DATA

Section 401(k)(3)(A)(ii), as amended, provides that a cash or deferred arrangement will not be treated as a qualified cash or deferred arrangement unless the actual deferral percentage for eligible HCEs for the plan year meets a nondiscrimination test when compared to the actual deferral percentage for all other eligible employees for the preceding plan year.

Thus, as amended, section 401(k)(3)(A)(ii) generally requires the comparison of the current year's ADP for HCEs to the prior

year's ADP for NHCEs.

For purposes of section 401(k)(3)(A)(ii), the actual deferral percentage for all other eligible employees for the preceding plan year is the ADP for the preceding plan year for the group of employees who were NHCEs in the preceding plan year, using the definition of HCE in effect for the preceding plan year.

> Thus, for purposes of section 401(k)(3)(A)(ii), the individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individuals section status in the current year.

For example, an individual who was an NHCE for the preceding plan year is included in this calculation even if:

the individual is no longer employed by the employer or

has become an HCE in the current plan year.

As a result, the prior year's ADP for NHCEs can be calculated as soon as the necessary data on prior year status, contributions and compensation become available.

For example, for the 1997 plan year, if a plan does not provide for matching contributions described in section 401(m)(4)(A) or qualified nonelective contributions described in section 401(m)(4)(C), **the ADP for the 1997 plan year of HCEs will be compared with the ADP for the 1996 plan year of NHCEs in 1996**, i.e., with the same ADP used in nondiscrimination testing for the 1996 plan year under prior law.

Future guidance will address the conditions under which and the extent to which matching contributions described in section 401(m)(4)(A) and qualified nonelective contributions described in section 401(m)(4)(C) may be taken into account in determining the current or prior year's ADP or ACP for NHCEs in nondiscrimination testing for the 1997 plan year and future plan years.

For purposes of determining the prior year's ACP for NHCEs under section 401(m)(2)(A), as amended, rules similar to those used in determining the prior year's ADP for NHCEs under section 401(k)(3)(A)(ii) will apply.

II. TRANSITION RELIEF FOR PLANS USING CURRENT YEAR ADP OR ACP DATA FOR THE 1997 PLAN YEAR

Under section 401(k)(3)(A)(ii) and section 401(m)(2)(A), as amended, an employer that elects to use current year data in determining the ADP or ACP of NHCEs for the 1997 plan year or for later plan years must continue to use current year data for all future plan years, unless the election is changed in a manner provided by the Secretary.

Under the transition relief provided by this notice, a plan that uses current year data in determining the ADP or ACP of NHCEs for the 1997 plan year will be permitted to use prior year data for the 1998 plan year without receiving approval from the Service. For the 1997 plan year, no plan amendment or formal election is required to be made in 1996 or 1997 in order to continue to use current year data in determining the ADP of NHCEs. The Treasury and the Service intend to issue guidance regarding the conditions under which employers that elect to use current year data for the 1998 or a later plan year may switch to using prior year data for subsequent plan years.

III. DISTRIBUTION OF EXCESS CONTRIBUTIONS AND EXCESS AGGREGATE CONTRIBUTIONS

Section 401(k)(8), as amended, provides a new procedure for correcting a plan sections failure to meet the nondiscrimination test of section 401(k)(3). Under section 401(k)(8)(B), which was not amended by the SBJPA, an excess contribution is determined for each HCE. Section 401(k)(8)(C), prior to amendment, and section 1.401(k)-1(f)(2) of the Income Tax Regulations provided for the distribution of this amount to each HCE. Parallel rules applied to correction of failure to satisfy the nondiscrimination test of section 401(m).

The SBJPA amended section 401(k)(8)(C) to provide that distributions of excess contributions for any plan year are made to HCEs on the basis of the amount of contributions by, or on behalf of, each HCE. This amendment does not affect the total amount of the excess contributions to be distributed, but merely reallocates the distributions among the HCEs.

Accordingly, in order to distribute excess contributions under section 401(k)(8), as amended, the following procedure is used:

1. Calculate the dollar amount of excess contributions for each affected HCE in a manner described in section 401(k)(8)(B) and section 1.401(k)-1(f)(2). However, in applying these rules, rather than distributing the amount necessary to reduce the actual deferral ratio (ADR) of each affected HCE in order of these employees' ADRs, beginning with the highest ADR, the plan uses these amounts in step 2.

2. Determine the total of the dollar amounts calculated in step 1.

   This total amount in step 2 (total excess contributions) should be distributed in accordance with steps 3 and 4 below:

3. The elective contributions of the HCE with the highest dollar amount of elective contributions are reduced by the amount required to cause that HCE's elective contributions to equal the dollar amount of the elective contributions of the HCE with the next highest dollar amount of elective contributions. This amount is then distributed to the HCE with the highest dollar amount. However, if a lesser reduction, when added to the total dollar amount already distributed under this step, would equal the total excess contributions, the lesser reduction amount is distributed.

4. If the total amount distributed is less than the total excess contributions, step 3 is repeated.

If these distributions are made, the cash or deferred arrangement is treated as meeting the nondiscrimination test of section 401(k)(3) regardless of whether the ADP, if recalculated after distributions, would satisfy section 401(k)(3).

A parallel method is used for the purpose of recharacterizing excess contributions under section 401(k)(8)(A)(ii) and for distributing excess aggregate contributions under section 401(m)(6)(C), as amended.

After excess and excess aggregate contributions, if any, have been distributed using the method described above, the multiple use test of section 401(m)(9) is applied. For purposes of section 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for

HCEs is deemed to be the largest amount permitted under section 401(k)(3). Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under section 401(m)(2).

The method described above for distributing excess contributions is illustrated by the following example:

COMPREHENSIVE EXAMPLE

For the 1997 plan year, HCE 1 has elective contributions of $8,500 and $85,000 in compensation, for an ADR of 10%, and HCE 2 has elective contributions of $9,500 and compensation of $158,333, for an ADR of 6%. As a result, the ADP for the 2 HCEs under the plan (HCE 1 and HCE 2) is 8%. The ADP for the NHCEs is 3%.

Under the ADP test of section 401(k)(3)(A)(ii), the ADP of the two HCEs under the plan may not exceed 5% (i.e., 2 percentage points more than the ADP of the NHCEs under the plan).

Pursuant to section 401(k)(8)(B), section 1.401(k)-1(f)(2), and this notice, the total excess contributions for the HCEs is determined as follows:

Step 1. The elective contributions of HCE 1 (the HCE with the highest ADR) are reduced by $3,400 in order to reduce the ADR of HCE 1 to 6% ($5,100/$85,000), which is the ADR of HCE 2.

Because the ADP of the HCEs still exceeds 5%, the ADP test of section 401(k)(3)(A)(ii) is not satisfied and further reductions in elective contributions are necessary. The elective contributions of HCE 1 and HCE 2 are each reduced by one percent of compensation ($850 and $1,583 respectively).

Because the ADP of the HCEs now equals 5%, the ADP test of section 401(k)(3)(A)(ii) is satisfied, and no further reductions in elective contributions are necessary.

Step 2. The total excess contributions for the HCEs that must be distributed equal $5,833, the total reductions in elective contributions under step 1 ($3,400 + $850 + $1,583).

Pursuant to section 401(k)(8)(C), the $5,833 in total excess contributions for the 1997 plan year would then be distributed as follows:

Step 3. The plan distributes $1,000 in elective contributions to HCE 2 (the HCE with the highest dollar amount of elective contributions) in order to reduce the dollar amount of the elective contributions of HCE 2 to $8,500, which is the dollar amount of the elective contributions of HCE 1.

Step 4. Because the total amount distributed ($1,000) is less than the total excess contributions ($5,833), step 3 must be repeated. As the dollar amounts of remaining elective contributions for both HCE 1 and HCE 2 are equal, the remaining $4,833 of excess contributions is then distributed equally to HCE 1 and HCE 2 in the amount of $2,416.50 each.

Under this example, HCE 1 must receive a total distribution of $2,416.50 of excess contributions, and HCE 2 must receive a total distribution of $3,416.50 of excess contributions. This is true even though the ADR of HCE 1 exceeded the ADR of HCE 2. The plan is now treated as satisfying the nondiscrimination test of section 401(k)(3) even though the ADP would fail to satisfy section 401(k)(3), if recalculated after distributions.

COMMENTS REQUESTED

The Treasury and the Service invite comments and suggestions regarding the matters discussed in this notice. Comments are specifically requested concerning:

, The use of qualified matching and qualified nonelective contributions in computing the prior year's ADP for NHCEs, including methods of preventing inappropriate double counting.

, The appropriate determination of the prior year's ADP for NHCEs when the group of employees tested is significantly different in the current year than in the prior year.

Comments can be addressed to CC:DOM:CORP:R (Notice 97-2), room 5228, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC

20044. In the alternative, comments may be hand delivered between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 97-2), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may transmit comments electronically via the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments/html.

DRAFTING INFORMATION

The principal authors of this notice are Kenneth Conn of the Employee Plans Division and Catherine Fernandez of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations). For further information regarding this notice, contact the Employee Plans Division's telephone assistance service between 1:30 and 4:00 p.m., Eastern Time, Monday through Thursday at (202) 622-6074/75 or Kenneth Conn at (202) 622-6214. (These telephone numbers are not toll-free numbers.)

Notice 98-1

I. PURPOSE

This notice provides guidance and transition relief relating to recent statutory amendments to the nondiscrimination rules under section 401(k) and section 401(m) of the Internal Revenue Code. The rules applicable to qualified cash or deferred arrangements under section 401(k) and matching and employee contributions under section 401(m) were amended by the Small Business Job Protection Act of 1996 (SBJPA), Pub. L. 104-188.

Specifically, this notice provides guidance on

1. The election to use the current year testing method.

2. The use of qualified nonelective contributions (QNCs) and qualified matching contributions (QMACs) under the prior year testing method.

3. The application of the first plan year rule under the prior year testing method.

4. The impact of certain plan population changes under the prior year testing method.

5. A change from the current year testing method to the prior year testing method, including related transition relief.

6. Plan amendments needed to reflect the testing method of a plan, including the application of the remedial amendment period under section 401(b).

II. BACKGROUND

A. SBJPA AMENDMENTS TO SECTION 401(K) AND SECTION 401(M)

Under section 401(k) and section 401(m), the actual deferral percentage (ADP) and the actual contribution percentage (ACP) of highly compensated employees (HCEs) are compared with those of nonhighly compensated employees (NHCEs). Section 1433(c) of SBJPA amended section 401(k)(3)(A) and section 401(m)(2)(A), effective for plan years beginning after December 31, 1996, to provide for the use of prior year data in determining the ADP and ACP for NHCEs, while continuing to provide for the use of current year data for HCEs. Alternatively, an employer may elect to use current year data for determining the ADP and ACP for both HCEs and NHCEs, but the statute provides that this election may be changed only as provided by the Secretary. Section 1433(d) of SBJPA amended section 401(k)(3) and section 401(m)(3) to provide a special rule for determining the ADP and ACP for NHCEs for the first plan year of a plan (other than a successor plan) where the prior year testing method is used.

B. PREVIOUS GUIDANCE ON THE SBJPA AMENDMENTS

Notice 97-2, 1997-2 I.R.B. 22, provides guidance on determining the individuals who are taken into account in computing the ADP or ACP for NHCEs for the prior year under the prior year testing method. The guidance provides transition relief to allow plans using the current year testing method for the 1997 testing year to change to the prior year testing method for the 1998 testing year without obtaining approval from the Internal Revenue Service.

The notice also provides rules for distributions of excess contributions and excess aggregate contributions.

Notice 97-2 states that Treasury and the Service will issue guidance regarding the conditions under which employers that elect to use current year data for the 1998 or a later plan year may change that election and use prior year testing for subsequent plan years. Notice 97-2 also requested comments concerning:

(i) the use of QNCs and QMACs in computing the prior year's ADP for NHCEs, including methods of preventing inappropriate double counting; and

(ii) the appropriate determination of the prior year's ADP for NHCEs when the group of employees tested is significantly different in the current year than in the prior year. After consideration of the comments received, this notice provides guidance on these issues.

Rev. Proc. 97-41, 1997-33 I.R.B. 51, provides guidance to sponsors of plans that are qualified under section 401(a) with respect to the date by which they must adopt amendments to comply with changes in the law, including a remedial amendment period for amendments to reflect changes to the qualification requirements made by SBJPA.

C. DEFINITIONS

If a term that is used in this notice is defined in the regulations under section 401(k) or section 401(m), then the definition under these regulations applies for purposes of this notice. For example, "plan" as used in this notice means plan as defined in section 1.401(k)-1(g)(11) of the Income Tax Regulations.

In addition, for purposes of this notice, the "testing year" is the plan year for which the ADP or ACP for HCEs is being tested; the "prior year" is the plan year immediately preceding the testing year. If the plan uses data from the testing year in determining the ADP or ACP for NHCEs, it is using the "current year testing method"; if the plan uses data from the prior year in determining the ADP or ACP for NHCEs, it is using the "prior year testing method."

Sections V and VI of this notice provide additional definitions used in applying the first plan year rule and definitions used in the rules relating to changes in the group of eligible employees when a plan uses the prior year testing method.

D. EFFECT OF STATUTORY CHANGES ON REGULATIONS

Because of the amendments made to section 401(k) and section 401(m), certain portions of section 1.401(k)-1 and section 1.401(m)-1 and 1.401(m)-2 no longer reflect current law. This notice provides guidance on a limited number of issues relating to the use of the prior year testing method and relating to a change in testing method. The regulations shall continue in force to the extent that they are not inconsistent with the Code, as amended, and subsequent guidance, including Notice 97-2 and this notice.

III. USE OF CURRENT YEAR TESTING METHOD

As provided under section 401(k)(3)(A) and section 401(m)(2)(A), an employer may elect to use the current year testing method for a plan in lieu of the prior year testing method.

A plan using the prior year testing method may adopt the current year testing method for any subsequent testing year.

> Notification to or filing with the Service of an election to use the current year testing method is not required in order for the election to be valid. However, as provided in section IX of this notice, the plan document governing the plan must reflect whether the plan uses the current year testing method or the prior year testing method for a testing year.

A plan that uses the current year testing method for a testing year may not be permissively aggregated under section 1.410(b)-7(d) with a plan that uses the prior year testing method for that testing year.

IV. USE OF QNCs AND QMACs UNDER PRIOR YEAR TESTING METHOD

Section 401(k)(3)(D) and section 401(m)(3) provide that an employer may take into account QNCs and QMACs in calculating the ADP, and QNCs in calculating the ACP, as provided by the Secretary. A plan may continue to take QNCs and QMACs into account under the prior year testing method, subject to the limitations set forth in section VII.B. of this notice.

A. TIMING OF CONTRIBUTION OF QNCS AND QMACS

In order to be taken into account in the calculation of the ADP or ACP for a year under the prior year testing method, a QNC or QMAC:

must be allocated as of a date within the year and

must actually be paid to the trust no later than the end of the 12-month period following the end of the year to which the contribution relates. See section 1.401(k)-1(b)(4)(i)(A) and (b)(5)(v) and section 1.401(m)-1(b)(4)(ii) and (b)(5)(iv).

Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP or ACP for NHCEs for the prior year, a QNC or QMAC must be contributed by the end of the testing year.

> Thus, for example, if the **prior year testing method** is used for the 1998 testing year, QNCs that are allocated to the accounts of NHCEs for the 1997 plan year (i.e., the prior year) must be contributed to the plan **by the end of the 1998 plan year** in order to be treated as elective contributions for purposes of the ADP test for the 1998 testing year.

By contrast, in order to be taken into account in calculating the ADP or ACP for HCEs for the 1998 testing year, a QNC or QMAC must be contributed by the end of the 1999 plan year.

It should be noted that section 1.415-6(b)(7)(ii) provides that, for purposes of satisfying section 415, employer contributions **shall not be deemed credited** to a participant's account for a particular limitation year unless the contributions are actually made to the plan **no later than 30 days after the end of the period described in section 404(a)(6)** applicable to the taxable year with or within which the particular limitation year ends.

> Thus, contributions made after the date described in section 1.415-6(b)(7)(ii) are treated as annual additions for the next section 415 limitation year.

Accordingly, under either the prior year testing method or the current year testing method, a violation of section 415(c) might occur if QNCs or QMACs are contributed after the date described in section 1.415-6(b)(7)(ii).

B. NONDISCRIMINATION TESTING OF QNCS UNDER THE PRIOR YEAR TESTING METHOD

Section 1.401(k)-1(b)(5) provides that

(i) the amount of nonelective contributions, including those QNCs treated as elective contributions for purposes of the ADP test, and

(ii) the amount of nonelective contributions, excluding those QNCs treated as elective contributions for purposes of the ADP test, must each satisfy the requirements of section 401(a)(4).

Under section 1.401(m)-1(b)(5), a similar rule applies to QNCs treated as matching contributions for purposes of the ACP test.

These nondiscrimination requirements continue to apply to plans that use the prior year testing method. This is true even though the QNCs allocated to the HCEs and NHCEs in a single plan year are taken into account for ADP and ACP testing in different testing years.

> Accordingly, QNCs allocated to the accounts of NHCEs and HCEs for the same plan year will be subject to the requirements of section 401(a)(4) for that plan year; however, QNCs allocated to the accounts of HCEs will be taken into account for ADP or ACP testing in the plan year for which they are allocated, while QNCs allocated to the accounts of NHCEs will not be taken into account in determining the permitted ADP or ACP for HCEs until the following plan year.

V. FIRST PLAN YEAR RULE UNDER PRIOR YEAR TESTING METHOD

Section 401(k)(3)(E) provides that, for the first plan year of any plan (other than a successor plan) that uses the prior year testing method, the ADP for NHCEs for the prior year is

3%, or,

if the employer elects, is the ADP for NHCEs for that first plan year.

For this purpose, the "first plan year" of any plan is the first year in which the plan, within the meaning of section 414(l), is or includes a section 401(k) plan (i.e., the first year a plan provides for elective contributions described in section 1.401(k)-1(g)(3)).

However, a plan does not have a first plan year if for such plan year the plan is aggregated under section 1.401(k)-1(g)(11) with any other plan that was or that included a section 401(k) plan in the prior year.

Section 401(m)(3) provides that rules similar to the rules of section 401(k)(3)(E) shall apply for purposes of the ACP test.

For purposes of the ACP test, the "first plan year" of any plan is the first year in which a plan, within the meaning of section 414(l), is or includes a section 401(m) plan (i.e., the first year a plan provides for employee contributions described in section 1.401(m)-1(f)(6) or matching contributions described in section 1.401(m)-1(f)(12), or both).

However, a plan does not have a first plan year if for such plan year the plan is aggregated for purposes of section 1.401(m)-1(g)(14) with any other plan that was or that included a section 401(m) plan in the prior year.

For purposes of this notice, a plan is a **"successor plan"** if 50% or more of the eligible employees for the first plan year were eligible employees under another section 401(k) plan (or section 401(m) plan, as applicable) maintained by the employer in the prior year.

For example, in 1998, Employer H sponsors Plan T, a section 401(k) plan. In 1999, Employer H establishes Plan U, also a section 401(k) plan, which had 200 eligible employees, including 100 employees who were eligible employees under Plan T in 1998. Plan U is a successor plan.

If a plan (other than a successor plan) uses the prior year testing method and for its first plan year the plan determines the ADP or ACP for NHCEs for the prior

plan year using the ADP or ACP for NHCEs for that first plan year (in lieu of 3%), then the use of the prior year testing method in the next testing year is not treated as a change in testing method.

Such a plan would not be subject to the limitations on double counting described in section VII.B. for that next testing year.

If a successor plan uses the prior year testing method for its first plan year, the ADP and ACP for NHCEs for the prior year are determined under the rules in section VI of this notice.

VI. CHANGES IN THE GROUP OF ELIGIBLE NHCEs WHERE PLAN USES PRIOR YEAR TESTING METHOD

A. GENERAL RULE: DISREGARD CHANGES IN THE GROUP OF NHCES

Except as provided in section VI.B. and C., below, under the prior year testing method, the ADP or ACP for NHCEs for the prior year under a plan is determined without regard to changes in the group of NHCEs who are eligible employees under the plan in the testing year.

Thus, under the prior year testing method, the prior year ADP or ACP for NHCEs is used:

even though some NHCEs may have first become eligible employees under the plan in the testing year because they meet existing plan eligibility requirements, and

even though individuals who were eligible employees under the plan and NHCEs in the prior year are no longer employed by the employer or have become HCEs in the testing year.

B. EXCEPTION FOR PLAN COVERAGE CHANGES

If a plan results from, or is otherwise affected by, a plan coverage change that becomes effective during the testing year, then the ADP and ACP for NHCEs for the prior year under the plan is the weighted average of the ADPs for the prior

year subgroups and the weighted average of the ACPs for the prior year subgroups, respectively.

C. OPTIONAL RULE FOR MINOR PLAN COVERAGE CHANGES

If:

a plan results from, or is otherwise affected by, a plan coverage change, and

90% or more of the total number of NHCEs from all prior year subgroups are from a single prior year subgroup,

then in determining the ADP or ACP for NHCEs for the prior year under the plan, an employer may elect to use the ADP and ACP for NHCEs for the prior year of the plan under which that single prior year subgroup was eligible, in lieu of using the weighted averages described in section VI.B., above.

D. DEFINITIONS

For purposes of this notice:

1. "Plan coverage change" means a change in the group or groups of eligible employees under a plan on account of:

   (a) the establishment or amendment of a plan,

   (b) a plan merger, consolidation, or spinoff under section 414(l),

   (c) a change in the way plans within the meaning of section 414(l) are combined or separated for purposes of section 1.401(k)-1(g)(11) (e.g., permissively aggregating plans not previously aggregated under section 1.410(b)-7(d), or ceasing to permissively aggregate plans under section 1.410(b)-7(d)), or

   (d) a combination of any of the foregoing.

2. "Prior year subgroup" means all NHCEs for the prior year who, in the prior year, were eligible employees under a specific section 401(k) plan (or, in

the case of the ACP test, a specific section 401(m) plan) maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior year instead of first being effective during the testing year.

3. "Weighted average of the ADPs for the prior year subgroups" and "weighted average of the ACPs for the prior year subgroups" mean the sum, for all prior year subgroups, of the adjusted ADPs and adjusted ACPs, respectively.

4. "Adjusted ADP" and "adjusted ACP" with respect to a prior year subgroup mean the respective ADP and ACP for NHCEs for the prior year of the specific plan under which the members of the prior year subgroup were eligible employees, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and the denominator of which is the total number of NHCEs in all prior year subgroups.

E. EXAMPLES

The requirements of this section VI are illustrated by the following examples:

Example 1:

(i) Employer B maintains two plans, Plan N and Plan P, each of which includes a section 401(k) plan. The plans were not permissively aggregated under section 1.410(b)-7(d) for the 1998 testing year. Both plans use the prior year testing method.

Plan N had 300 eligible employees who were NHCEs for 1998, and their ADP for that year was 6%.

Plan P had 100 eligible employees who were NHCEs for 1998, and the ADP for those NHCEs for that plan was 4%.

Plan N and Plan P are permissively aggregated under section 1.410(b)-7(d) for the 1999 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 1999 testing year under section 1.410(b)-7(d) is a plan coverage change that results in

treating the plans as one plan (Plan NP) for purposes of section 1.401(k)-1(g)(11).

Therefore, the prior year ADP for NHCEs under **Plan NP** for the 1999 testing year is the weighted average of the ADPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ADPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 1999 testing year, an employee is a member of a prior year subgroup if the employee

(A) was an NHCE of Employer B for the 1998 plan year,

(B) was an eligible employee for the 1998 plan year under any section 401(k) plan maintained by Employer B, and

(C) would have been an eligible employee in the 1998 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under section 1.410(b)-7(d) for that plan year.

The NHCEs who were eligible employees under separate section 401(k) plans for the 1998 plan year comprise separate prior year subgroups.

Thus, there are two prior year subgroups under Plan NP for the 1999 testing year:

the 300 NHCEs who were eligible employees under Plan N for the 1998 plan year and

the 100 NHCEs who were eligible employees under Plan P for the 1998 plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of:

(A) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and

(B) the adjusted ADP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P.

The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows:

6% (the ADP for the NHCEs under Plan N for the prior year) x 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%.

The adjusted ADP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows:

4% (the ADP for the NHCEs under Plan P for the prior year) x 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%.

Thus, the prior year ADP for NHCEs under Plan NP for the 1999 testing year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

Example 2:

(i) Employer C maintains a plan, Plan Q, which includes a section 401(k) plan and which uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 1998, Plan Q had 500 eligible employees who were NHCEs, and the ADP for those NHCEs for 1998 was 5%.

Effective January 1, 1999, Employer C spins off a portion of Plan Q under section 414(l), creating a new Plan R which includes a section 401(k) plan in which the 100 employees of Division B are eligible employees.

(ii) The spin-off of Plan R is a plan coverage change that affects Plan Q. Accordingly, for purposes of the 1999 testing year under Plan Q, the prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups.

Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q

for the 1998 plan year if the spin-off had occurred as of the first day of that plan year were eligible employees under Plan Q).

Therefore, for purposes of the 1999 testing year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as if the plan spin-off had not occurred.

Example 3:

(i) The facts are the same as in Example 2, except that instead of spinning off Plan R from Plan Q, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 1999. In addition, effective on that same date, Employer C establishes a new plan, Plan R, which includes a section 401(k) plan that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of section V of this notice (because all of the employees were eligible employees under Plan Q in the prior year), and, therefore, the first plan year rule of that section does not apply.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes that affect Plan Q and result in Plan R. Accordingly, the prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 1998 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 1999 testing year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as if the plan amendment had not occurred.

(iv) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 1998 plan year if the plan were established as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 1999 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as that of Plan Q.

Example 4:

(i) The facts are the same as in Example 3, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any section 401(k) plan maintained by Employer C.

(ii) Plan R is a successor plan, within the meaning of section V of this notice (because 100 of Plan R's 150 eligible employees were eligible employees under another section 401(k) plan maintained by Employer C in the prior year), and, therefore, the first plan year rule of that section does not apply.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any section 401(k) plan of Employer C for the prior year, they do not comprise a prior year subgroup.

Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 1999 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 5%, the same as that of Plan Q.

VII. CHANGE FROM CURRENT YEAR TO PRIOR YEAR TESTING METHOD

A. GENERAL RULE

Section 401(k)(3)(A) provides that if an employer elects to use the current year testing method for purposes of the ADP test, that method may not be changed except as provided by the Secretary. A similar rule applies under section 401(m)(2)(A) in the case of the ACP test. Thus, the statute indicates that once an employer elects to use the current year testing method, the ability to change that election will be limited.

In general, it is expected that plans will select a testing method and retain it. Treasury and the Service recognize, however, that there may be legitimate reasons for occasionally reevaluating and changing the testing method under a plan. In addition, certain business transactions may result in a diversity of testing methods among plans of an employer, and the employer may wish to use

consistent testing methods. Finally, Treasury and the Service believe that employers with existing plans should be given a period of time to decide whether to change from the current year testing method (which was the required testing method prior to the SBJPA changes) to the prior year testing method.

Accordingly, a plan is permitted to change from the current year testing method to the prior year testing method in any of the following situations:

1. The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan).

2. The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan).

3. A transaction occurs that is described in section 410(b)(6)(C)(i) and section 1.410(b)-2(f); as a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and the change from the current year testing method to the prior year testing year method occurs within the transition period described in section 410(b)(6)(C)(ii).

4. The change occurs during the plan's remedial amendment period for the SBJPA changes (see Rev. Proc. 97-41).

Notification to or filing with the Service of a change from the current year to the prior year testing method is not required in order for the change to be valid. However, as provided in section IX of this notice, the plan document governing the plan must reflect such a change.

B. LIMITATIONS ON DOUBLE COUNTING OF CERTAIN CONTRIBUTIONS

If a plan **changes from the current year testing method to the prior year testing method**, then, for purposes of the first testing year for which the change is effective, the ADP and ACP for NHCEs for the prior year is determined in the following manner:

1. The ADP for NHCEs for the prior year is determined taking into account only

   (a) elective contributions for those NHCEs that were taken into account for purposes of the ADP test (and not the ACP test) under the current year testing method for the prior year and

   (b) QNCs that were allocated to the accounts of those NHCEs for the prior year but that were not used to satisfy the ADP test or the ACP test under the current year testing method for the prior year.

2. The ACP for NHCEs for the prior year is determined taking into account only

   (a) employee contributions for those NHCEs for the prior year,

   (b) matching contributions for those NHCEs that were taken into account for purposes of the ACP test (and not the ADP test) under the current year testing method for the prior year, and

   (c) (c) QNCs that were allocated to the accounts of those NHCEs for the prior year but that were not used to satisfy the ACP test or the ADP test under the current year testing method for the prior year.

Thus, in determining the ADP for NHCEs for the prior year, the following contributions made for the prior testing year are disregarded:

(a) QNCs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year,

(b) elective contributions taken into account for purposes of the ACP test, and

(c) all QMACs.

Similarly, in determining the ACP for NHCEs for the prior year, the following contributions made for the prior testing year are disregarded:

(a) QNCs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year,

(b) QMACs taken into account for purposes of the ADP test, and

(c) all elective contributions.

The limitations on double counting under this section VII.B. do not apply for testing years beginning before January 1, 1999. Accordingly, in the case of a plan that changes from the current year to the prior year testing method for the first time for either the 1997 or 1998 testing year, the ADP and ACP for NHCEs used for that testing year are the same as the ADP and ACP, respectively, for NHCEs used for the prior testing year.

Examples

The limitations on double counting are illustrated by the following examples:

Example 1:

(i) Employer A established Plan M, a calendar year section 401(k) plan, in 1993 and, through the 2000 testing year, has always used the current year testing method under Plan M. The ADP for the HCEs under Plan M is 7% for the 2000 testing year. Based solely on elective contributions by NHCEs under Plan M for the 2000 testing year, the ADP for NHCEs for the 2000 testing year is 4%.

In order to satisfy the ADP test, Employer A provides a QNC to each NHCE for the 2000 testing year equal to 1% of compensation. No other contributions under Plan M are taken into account in determining the ADP for NHCEs. Thus, the ADP for NHCEs for the 2000 testing year is 5%.

Plan M is amended to use the prior year testing method instead of the current year testing method for purposes of the ADP test for the 2001 testing year.

(ii) In determining the ADP for NHCEs under Plan M for the 2001 testing year in accordance with the prior year testing method, the elective contributions made by NHCEs under Plan M for the 2000 plan year are taken into account.

However, the QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs for the 2000 plan year are disregarded because they were used to satisfy the ADP test for the 2000 testing year. Thus, for purposes of the 2001 testing year, the ADP for NHCEs for the prior year is 4% (unless additional QNCs for NHCEs are timely contributed and allocated for the 2000 plan year).

Example 2:

(i) The facts are the same as in Example 1, except that the testing years are 1997 and 1998, instead of 2000 and 2001.

(ii) For purposes of the 1998 testing year, the ADP for NHCEs for the prior year is 5%. The QNCs equal to 1% of compensation made under Plan M on behalf of NHCEs that were used to satisfy the ADP test for the 1997 testing year are not disregarded because the limitation on double counting applies only for testing years beginning on or after January 1, 1999.

VIII. ANTI-ABUSE PROVISION

This guidance is designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the prior year ADP and ACP for NHCEs (which are used as benchmarks for testing the ADP and ACP for HCEs). Further, the ADP and ACP tests are part of the overall requirement that benefits or contributions not discriminate in favor of HCEs.

Therefore, a plan will not be treated as satisfying the ADP or ACP test if there are repeated changes in plan testing procedures or plan provisions that have the effect of distorting the ADP or ACP test so as to increase significantly the permitted ADP or ACP for HCEs and if a principal purpose of the changes was to achieve such a result.

IX. PLAN PROVISIONS REGARDING TESTING METHOD

Sections 1.401(k)-1(b)(2)(iii) and 1.401(m)-1(b)(2) require that a plan to which section 401(k) or section 401(m) applies must provide that the ADP or ACP test will be met. Because a plan may now use either the current year testing method or the prior year testing method, a plan must specify which of these two testing methods it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change. Further, for purposes of the first plan year rule described in section 401(k)(3)(E) and section 401(m)(3) and section V of this notice, the plan must specify whether the ADP and ACP for NHCEs for the prior plan year is 3% or the current year's ADP and ACP for the NHCEs.

The regulations under section 401(k) and section 401(m) permit a plan to incorporate by reference section 401(k)(3) and section 401(m)(2) (and, if applicable, section 401(m)(9)) and the specific underlying regulations. A plan that incorporates these provisions by reference

must continue to refer to the applicable Code sections and the specific underlying regulations,

must specify which of the two testing methods (prior year or current year) it is using, and

must now provide that it is incorporating by reference subsequent Internal Revenue Service guidance issued under the applicable Code provisions.

Further, for purpose of the first plan year rule described in section 401(k)(3)(E) and section 401(m)(3) and section V of this notice, a plan that incorporates these provisions by reference must specify whether the ADP and ACP for NHCEs for the prior plan year is 3% or the current year's ADP and ACP for the NHCEs.

Rev. Proc. 97-41 provides that qualified retirement plans have a remedial amendment period under section 401(b) so that certain plan amendments for SBJPA generally are not required to be adopted before the last day of the first plan year beginning on or after January 1, 1999.

Pursuant to Rev. Proc. 97-41, a plan provision reflecting the ADP or ACP testing method is a disqualifying provision, and thus any plan amendments to reflect a

choice in testing method are not required to be adopted until the end of this remedial amendment period.

However, plans must be operated in accordance with the SBJPA changes to section 401(k)(3)(A) and section 401(m)(2)(A) as of the statutory effective date. In addition, under Rev. Proc. 97-41, any retroactive amendments

> must reflect the choices made in the operation of the plan for each testing year, including the choice of testing method (and any changes to that election), and
>
> must reflect the date on which the plan began to operate in accordance with those choices (and any such changes).

X. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1579.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collection of information in this notice is in section IX. This requirement to amend plan documents is necessary to reflect the new nondiscrimination test under section 401(k)(3) and section 401(m)(2) as amended by SBJPA. The pre-SBJPA method of nondiscrimination testing is still available under these Code sections and a plan amendment may not be required to reflect the choice of the pre-SBJPA testing method. The information will be used to determine whether the ADP and ACP of HCEs exceeds the ADP and ACP of NHCEs by more than the statutory limits. The collection of information is required to obtain a benefit. The likely respondents are businesses or other for-profit institutions, and nonprofit institutions.

The estimated total annual recordkeeping burden is 49,000 hours. The estimated annual burden per recordkeeper is 20 minutes. The estimate number of recordkeepers is 147,000.

Books or records relating to a collection of information must be retained as long

as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

XI. COMMENTS

Treasury and the Service invite comments regarding the matters discussed in this notice. Comments may be submitted to the Service at CC:DOM:CORP:R (Notice 98-1), Room 5226, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Alternatively, taxpayers may hand-deliver comments between the hours of 8 a.m. and 5 p.m. to CC:DOM:CORP:R (Notice 98-1), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, N.W., Washington, D.C., or may submit comments electronically via the Service's Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html.

Drafting Information

The principal authors of this notice are Susan Lennon of the Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations) and Roger Kuehnle of the Employee Plans Division. For further information regarding this notice, contact the Employee Plans Division's telephone assistance service between 1:30 and 4:00 p.m., Eastern Time, Monday through Thursday at (202) 622-6074/75. (These telephone numbers are not toll-free.)

Rev. Rul. 2000-27

Section 401. -Qualified Pension, Profit-Sharing, Stock Bonus Plans, etc.

26 CFR 1.401(k)-1: Certain cash or deferred arrangements.

May 22, 2000

ISSUE

Will a distribution of amounts deferred by an employee under a cash or deferred arrangement under § 401(k) of the Internal Revenue Code be considered to have been made earlier than the employee's "separation from service," within the meaning of § 401(k)(2)(B)(i)(I), if the distribution is made after the sale to an unrelated employer of assets constituting less than substantially all of the assets of a trade or business of the employee's employer?

FACTS

Employer X maintains Plan A, which is a profit-sharing plan intended to satisfy the requirements of § 401(a) of the Code. Plan A includes a cash or deferred arrangement that is intended to be a qualified cash or deferred arrangement under § 401(k). Plan A provides that salary reduction contributions are immediately nonforfeitable and, if the employee has not attained age 59 1/2, cannot be distributed prior to the employee's retirement, death, disability, or separation from service, except in the case of hardship (as defined in the plan), plan termination (to the extent permitted by § 401(k)(10)) or a transaction described in § 401(k)(10)(A)(ii) or (iii).

Employer X sells certain assets to Employer Y, an entity not required to be aggregated with Employer X under § 414(b), (c), (m) or (o) after the sale. The assets sold to Employer Y constitute less than 85% of the assets used by Employer X in a trade or business of Employer X. Most of the employees of Employer X who were associated with the transferred assets terminate their employment with Employer X and are hired by Employer Y (the "Transferred Employees") as of the date of the sale of assets. Transferred Employees continue to perform, without interruption and in the same capacity, the same functions for Employer Y that they performed for Employer X

before the sale. Additionally, Employer X is no longer the recipient of the services of the Transferred Employees.

Following the sale of assets, the administrator of Plan A allows all of the Transferred Employees to receive a distribution of their Plan A account balances, including amounts attributable to elective contributions. There is no transfer of amounts from Plan A to any plan maintained by Employer Y in connection with the Transferred Employees (although there were direct rollovers of distributions pursuant to § 401(a)(31)).

LAW AND ANALYSIS

Section 401(k) of the Code provides that a profit-sharing plan that includes a cash or deferred arrangement can meet the requirements of § 401(a), provided that the cash or deferred arrangement constitutes a qualified cash or deferred arrangement.

Section 401(k)(2)(B)(i) provides that amounts attributable to employer contributions made pursuant to an employee's election may not be distributable from a profit-sharing plan earlier than (I) the employee's separation from service, death or disability; (II) an event described in § 401(k)(10); (III) the employee's attainment of age 59 1/2; or (IV) the employee's hardship. Events described in § 401(k)(10) include (i) the termination of the plan; (ii) the disposition by a corporation to another corporation of substantially all the assets used by the selling corporation in a trade or business; and (iii) the disposition of a corporation's interest in a subsidiary.

Sections 1.401(k)-1(d)(1)(iv), 1.401(k)-1(d)(4) and 1.401(k)-1(d)(5) of the Income Tax Regulations interpret § 401(k)(10). Section 1.401(k)-1(d)(1)(iv) generally provides that amounts in a plan attributable to elective contributions may be distributed on or after the date of the sale or other disposition by a corporation of substantially all the assets used by the corporation in a trade or business of the corporation to an unrelated corporation. Section 1.401(k)-1(d)(4) further provides that (i) after the sale, the purchaser must not maintain the plan; (ii) the employee receiving the distributions must continue employment with the purchaser of the assets; and (iii) the distribution must be made in connection with the disposition of assets. Finally, § 1.401(k)-1(d)(4) provides that the sale of substantially all the assets used in a trade or business means the sale of at least 85% of the assets, and an unrelated entity is one that is not required to be aggregated with the seller under §§ 414(b), (c), (m) or (o) after the sale or other disposition. Section 1.401(k)-1(d)(5) provides that a distribution may be made only if it is a lump sum distribution within the meaning of § 402(d)(4).

For tax years beginning prior to January 1, 2000, § 402(d) provided special forward averaging treatment for lump sum distributions from plans qualified under § 401(a). Section 402(d)(4)(A) provided that a lump sum distribution was a distribution or payment within one taxable year of the recipient of the balance to the credit of an employee which becomes payable to the recipient upon one of several events, including a "separation from service." Special forward averaging treatment of lump sum distributions was generally repealed by § 1401(a) and (c)(2) (subject to limited grandfather treatment) as part of the Small Business Job Protection Act of 1996, P. L. 104-188.

Rev. Rul. 79-336, 1979-2 C.B. 187, provides that, for purposes of the special forward averaging treatment of lump sum distributions under the earlier § 402(d), an employee will be considered separated from service within the meaning of § 402(d)(4)(A) (formerly § 402(e)(4)(A)) only upon the employee's death, retirement, resignation, or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, or consolidation, etc. of the former employer.

Employer X's sale of less than 85% of the assets in a trade or business to Employer Y does not constitute a sale of substantially all the assets used in a trade or business within the meaning of 401(k)(10)(A)(ii). Consequently, Employer X's sale of certain assets to Employer Y is not covered by § 401(k)(10). Thus, Plan A may distribute the accounts of Transferred Employees if the change in their employment status as a result of the sale to Employer Y constitutes a "separation from service" within the meaning of § 401(k)(2)(B)(i)(I). In the circumstances considered here, the Transferred Employees are not employed in a continuation of the same trade or business. Under these facts, there has been a sufficient change in the employment status of the Transferred Employees to constitute a "separation from service" within the meaning of § 401(k)(2)(B)(i)(I).

Accordingly, the distributions from Plan A were made after the Transferred Employees' "separation from service" within the meaning of § 401(k)(2)(B)(i)(I).

HOLDING

The change in the status of Transferred Employees following the sale of less than substantially all of the assets of a trade or business of Employer X to Employer Y constitutes a "separation from service" within the meaning of § 401(k)(2)(B)(i)(I), as of the date of the sale of assets (when their employment with Employer X terminated). Accordingly, Plan A will not fail to meet the requirements of § 401(k)(2)(B) merely because Transferred Employees are permitted to receive distributions of their account

balances, including amounts attributable to elective contributions. This holding is the same regardless of: (i) whether Employer X or Employer Y is a corporation, or (ii) whether Employer Y hires Transferred Employees pursuant to a contractual obligation.

With respect to any sale of less than substantially all the assets of a trade or business under the facts described above occurring prior to September 1, 2000, the Internal Revenue Service will not treat the plan as failing to follow its provisions merely because the employer does not treat the termination of employment from the seller and the hiring by the buyer as a "separation from service" within the meaning of § 401(k)(2)(B) and therefore does not permit distributions from the plan to the terminated employees hired by the buyer.

DRAFTING INFORMATION

The principal authors of this revenue ruling are Steven J. Linder of the Tax Exempt and Government Entities Division (T:EP) and R. Lisa Mojiri-Azad of the Office of Chief Counsel (EBEO). For further information regarding this revenue ruling, contact the Employee Plan's taxpayer assistance telephone service between the hours of 1:30 and 3:30 p.m. Eastern time, Monday through Thursday, by calling (202) 622-6074. Mr. Linder can be reached at (202) 622-6214. Ms. Mojiri-Azad can be reached at (202) 622-6030. (These telephone numbers are not toll-free numbers.)