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PURPOSE

This transmits complete reprint with changes for IRM 4.72.2, Employee Plans Technical Guidance, Cash or Deferred Arrangements (CODAs).

BACKGROUND

IRM text pertaining to IRM 7.7.1, Chapter 2 (formerly, IRM 7(10)54:440) has been reorganized and renumbered as IRM 4.72.2. This IRM material reflects the new simplified format and style.

NATURE OF CHANGES

This IRM text provides guidance for examiners on cash or deferred arrangements (CODAs) for plan years beginning after December 31, 1996. This transmittal reissues existing procedures, updates the text for law changes, and reorganizes the material. This material replaces and obsoletes text currently contained in the following IRM sections: IRM 7.7.1, Chapter 2 (formerly, IRM 7(10)54:440), using the same catalog number.

INTENDED AUDIENCE

TEGE (Employee Plans)

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Distribution: IRM 4.72.2

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4.72.2.1 (03-01-2002)
Overview of Section 2

(1) The information contained in this section 2 is designed primarily to assist EP examiners in identifying relevant issues relating to cash or deferred arrangements (CODAs) for plan years beginning after December 31, 1996.

(2) This section 2 reflects statutory changes made by the Uniformed Services Employment and Reemployment Rights Act of 1994, Pub. L. 103-353 (USERRA), the Small Business Job Protection Act of 1996, Pub. L. 104-188 (SBJPA), the Taxpayer Relief Act of 1997, Pub. L. 105-34 (TRA), the Internal Revenue Service Restructuring and Reform Act of 1998, Pub. L. 105-206 (RRA) and all guidance issued by the Service prior to 2001. In addition this section also reflects several changes made by the Community Renewal Tax Relief Act of 2000, Pub. L. 106-554 (CRA), and the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. 107-16 (EGTRRA), that have retroactive effect.

4.72.2.2 (03-01-2002)
Overview of CODAs

(1) A CODA is an arrangement that allows participants to elect between cash (or some other taxable benefit) or an employer contribution to a deferred compensation plan on the participants' behalf. The election must be made before the taxable benefit is "currently available" to the participant. A qualified CODA is a CODA that satisfies the requirements of IRC section 401(k), and a nonqualified CODA is one that does not satisfy the requirements of IRC section 401(k).

(2) Except where clearly specified, these guidelines assume a CODA is intended to be a qualified CODA (and will use the term "CODA" to mean a qualified CODA), since only qualified CODAs get the benefit of tax deferral. Under IRC section 402(e)(3), contributions made pursuant to a CODA election to a qualified CODA are not included in participants' gross income until distributed, even though participants had the right to receive the contribution as taxable wages in the year contributed.

4.72.2.2.1 (03-01-2002)
Recent Changes to CODAs

(1) The statutes listed above in IRM 4.72.2.1 made the CODA-related changes listed in (2), (3), (4) and (5) below.

(2) Effective in 1997:

a. 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 CODAs.
b. 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 section 401(k) plans of such entities.
c. IRC sections 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.

d. IRC sections 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.
e. 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.
f. IRC section 414(q) was amended by section 1431 of SBJPA to repeal the family aggregation rules and simplify the definition of HCE.
g. Section 664 of EGTRRA directed the Secretary of the Treasury to amend the regulations under IRC section 410(b) to provide that employees who are eligible to make elective deferrals under a section 403(b) annuity maintained by a 501(c)(3) tax-exempt entity may be treated as excludable employees with respect to a 401(k) plan maintained by the same employer if certain conditions are satisfied.

(3) Effective in 1998:

a. IRC section 401(k)(7) was amended by section 1525 of TRA to permit certain mutual irrigation and drainage companies to maintain CODAs.
b. 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.
c. 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.
d. IRC section 415(c)(3) was further amended by section 314(e) of CRA to add IRC section 132(f)(4) elective amounts to the definition of compensation, effective for years beginning after 1997. See Notice 2001-37, 2001-25 I.R.B. 1340.

(4) Effective in 1999:

a. IRC sections 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 sections 401(k) and 401(m).
b. IRC sections 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.
c. 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.

(5) In addition to the above, USERRA, codified at 38 U.S.C. sections 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, now codified at

IRC section 414(u), which was added to the Code by section 1704(n) of SBJPA. IRC section 414(u) provides that employees are entitled to make catch-up elective deferrals and receive any matching contributions on those deferrals for an absence due to military service. IRC section 414(u) is effective as of December 12, 1994, but a plan has to the end of the SBJPA remedial amendment period to amend for IRC section 414(u). For a summary of the requirements of USERRA and IRC section 414(u), see Rev. Proc. 96-49, 1996-2 CB 369.

(6) In addition to the statutory changes, the Service released the following guidance on section 401(k) plans in the last few years:

a. Notice 97-2, 1997-1 C.B. 348, dealing with the methodology of prior year testing and correction.
b. Rev. Proc. 97-9, 1997-1 C.B. 624, relating to SIMPLE 401(k) plans and providing a model amendment.
c. Notice 98-1, 1998-1 C.B. 327, providing guidance on prior year testing.
d. Notice 98-52, 1998-2 C.B. 632, and Notice 2000-3, 2000-4 I.R.B. 413, providing guidance on safe harbor plans.
e. 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.
f. Rev. Rul. 2000-8, 2000-7 I.R.B. 617, dealing with automatic enrollment (“negative elections”) features.
g. Rev. Rul. 2000-27, 2000-27 I.R.B. 1016, providing guidance on when a separation from service has occurred.

(7) Due to all these recent changes, the regulations under IRC section 401(k) do not reflect current law. However, they are still valid to the extent they are not inconsistent with the items listed in (2) through (6) above.

4.72.2.3 (03-01-2002)

Eligible Employer and Plan

(1) Any employer, other than a State or local government, can establish a CODA and a State or local government that had a CODA on May 6, 1986, can continue it and even establish new ones. (See the Field Directive on grandfathered CODAs, issued on March 12, 1992.) A tax-exempt organization, other than a rural co-op, could not establish a CODA during the period between May 6,1986, and January 1, 1997. (See section 1116 of the Tax Reform Act of 1986.) Indian tribal governments and related entities can also establish a CODA (see IRC section 401(k)(4)(B)(iii)). Thus, sole proprietors, partnerships, corporations and agencies of the Federal government are all eligible to establish CODAs.

(2) In addition to meeting the requirements in (1) above, an employer intending to establish a SIMPLE 401(k) plan as described in IRC section 401(k)(11) must satisfy the 100-employee rule stated in IRC section 408(p)(2)(C)(i).

(3) A CODA must be part of a profit-sharing plan, a stock bonus plan, a pre-ERISA money purchase plan or a rural cooperative plan. See IRC section 401(k)(1), (2) and (6). Since a CODA is part of a qualified plan, the failure of the CODA to satisfy IRC section 401(k) will not always result

in the failure of the plan to satisfy IRC section 401(a). For example, a CODA in a profit-sharing plan does not automatically disqualify the plan merely because the CODA failed the ADP test, although, in such case, the plan will most likely have failed to follow its terms, providing alternative grounds for disqualification. On the other hand, a CODA that is part of a defined benefit plan would disqualify the entire plan because such plans are not permitted to contain CODAs.

(4) Sometimes the term “section 401(k) plan” is used to denote a plan that properly contains a CODA and that may or may not provide for one or more types of other contributions, such as employee (after-tax) contributions, and employer matching and nonelective contributions. However, under the regulations, a “section 401(k) plan” is the portion of a plan consisting only of elective contributions, and a “CODA” is the portion of a plan consisting of elective contributions plus QNECs and QMACs that are treated as elective contributions.

4.72.2.4 (03-01-2002)
Common Abbreviations

(1) For brevity, this text uses some common abbreviations for frequently used terms. Such terms are briefly defined in this IRM 4.72.2.4, but will be discussed in greater detail in the relevant parts of this section 2 and IRM 4.72.3 (Employee Contributions and Matching Contributions).

(2) “ECs,” or “elective contributions,” are the contributions made to a plan pursuant to an employee’s CODA election. These contributions are included in the definition of elective deferrals under IRC section 402(g) and are treated as employer contributions for most purposes under the Code, including IRC sections 401(a), 401(k), 402, 404, 409, 411, 412, 415, 416, and 417. However, ECs are counted as part of the employee’s wages for FICA withholding, FUTA, and Railroad Retirement tax, and are treated as plan assets for purposes of Title I of ERISA under the Department of Labor’s rules.

(3) “ADR,” or “actual deferral ratio,” is an employee’s ECs (and amounts treated as ECs) for a plan year divided by the employee’s compensation for the plan year.

(4) “ADP,” or “actual deferral percentage,” is the average of the ADRs for the relevant group of employees. It is used in discussions about the ADP test, an anti-discrimination test contained in IRC section 401(k)(3)(A)(ii).

(5) “ACR,” or “actual contribution ratio,” is the sum of an employee’s employee contributions and matching contributions (and amounts treated as matching contributions) for a plan year divided by the employee’s compensation for the plan year.

(6) “ACP,” or “actual contribution percentage,” is the average of the ACRs for the relevant group of employees. It is used in discussions about the ACP test, an anti-discrimination test contained in IRC section 401(m)(2)(A).

(7) “QNECs” (sometimes “QNCs”), or “qualified nonelective contributions,” are special employer contributions that are not subject to a CODA election. They are always fully vested and are subject to certain

distribution restrictions. They may be treated as ECs or matching contributions in the ADP test or ACP test, respectively.

(8) “QMACs,” or “qualified matching contributions,” are employer matching contributions that are always fully vested and are subject to certain distribution restrictions. They are counted in the ACP test unless they are treated as ECs, in which case they are counted in the ADP test.

4.72.2.5 (03-01-2002)
CODA Defined

(1) A CODA is an arrangement under which an eligible employee may make a cash or deferred election with respect to benefits under a plan. It does not include an arrangement under which amounts contributed at an employee’s election are treated at the time of contribution as after-tax employee contributions

(2) Any plan which allows a participant an election between receiving cash (or some other taxable benefit) and having an amount contributed on his or her behalf to a plan has a CODA. As noted above, only certain plans may contain CODAs and only certain employers may maintain plans with CODAs. If the employee is not permitted to receive cash as one of the choices, then the CODA does not satisfy IRC section 401(k).

4.72.2.5.1 (03-01-2002)
Cash or Deferred Election

(1) A cash or deferred election is any election (or modification of a previous election) by an employee to have the employer either:

a. provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available to the employee at the time of the election, or
b. contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

(2) An amount is not currently available if the employee does not yet have a right to receive that amount or if there is a significant restriction on the employee’s right to receive the amount. For example, an amount is not currently available if it has not yet been earned or if payday has yet to arrive. Also, an election can only be made with respect to amounts that would become currently available after the later of the date the cash or deferred arrangement is adopted or the date it first becomes effective.

(3) Usually the election is in the form of a salary reduction agreement, where an eligible employee agrees to reduce his or her cash compensation, or forgo an increase in cash compensation, in exchange for the employer making a plan contribution in an amount equal to the reduction. However, the election may also be a “negative election,” whereby an eligible employee’s cash compensation is automatically reduced by a percentage specified in the plan and such amount is contributed to the plan unless the employee affirmatively elects otherwise. Under these so-called “automatic enrollment” plans, employees must be given a reasonable opportunity to elect to have a different amount or no amount at all contributed under the arrangement. (See Rev. Rul. 2000-8.)

4.72.2.5.2 (03-01-2002)
Certain One-Time Elections

(1) A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer, or upon the employee's first becoming eligible under any plan of the employer, to have or not to have a specified amount contributed to the plan and to any other plan of the employer (including plans not yet established) for the duration of the employee's employment with the employer. Thus, if these were the only elections available under a plan, such plan would not be considered to contain a CODA, and contributions made to a plan pursuant to such an election would not be considered to be elective contributions.

(2) Once an employee has participated in any plan of the employer, he or she cannot make this one-time election. In addition, a change in status, such as from associate to partner, or union employee to manager, does not give rise to a new one-time election.

(3) A plan giving this one-time irrevocable election is subject to the regular, non-CODA nondiscrimination rules. Thus, such one-time election must be offered to a nondiscriminatory group, and the plan as a whole must satisfy the regular nondiscrimination rules.

4.72.2.5.3 (03-01-2002)
Partnership Rules

(1) Under the partnership taxation rules, a contribution made on behalf of a partner to a plan of a partnership is allocated to that partner and deducted on his or her income tax return. The remaining portion of the partner's distributive share of partnership income is payable directly to the partner. Thus, if a partner can individually choose to vary the plan contribution made on his or her behalf, this is a cash or deferred election. Rev. Proc. 91-47 provided limited relief for partnership plans that allowed partners to individually vary their plan contributions. The plan had to be amended by the end of 1992 to become either a qualified CODA or a plan without variable contributions.

(2) Also due to the nature of the partnership taxation rules, and the definition of elective contributions, in a partnership CODA, matching contributions made to partners fall within the definition of elective contributions, because, by varying a partner's elective contributions, any match on such elective contributions would reduce the partner's compensation. (It is a cash or deferred election because a partner can choose, indirectly, to have an amount contributed to the plan — in this case matching contributions — or receive the amount in cash simply by varying the amount of his or her elective contributions.) This was changed for plan years beginning after December 31, 1997, when section 1501 of TRA added IRC section 402(g)(9) to provide that matching contributions of self-employed individuals, including partners, are not elective contributions.

(3) The regulations under IRC section 401(k) provide that for purposes of a cash or deferred election a partner's compensation is deemed currently available on the last day of the partnership taxable year. Thus, a partner can make a cash or deferred election with respect to a year's compensation any time before (but not after) the last day of the year,

even though the partner takes “draws” against his or her expected share of partnership income throughout the year.

4.72.2.5.4 (03-01-2002)
Qualified CODAs

(1) As already mentioned, this section of the IRM assumes a qualified CODA is intended. To be a qualified CODA, the arrangement must satisfy the requirements specified in IRC section 401(k). These are:

a. The CODA must be part of an eligible plan maintained by an eligible employer.
b. The employee’s election must be between cash (rather than some other taxable benefit) and deferral.
c. Elective contributions are not distributable prior to certain events.
d. Elective contributions are nonforfeitable at all times.
e. The CODA satisfies the participation requirements of IRC section 410(b)(1).
f. The CODA satisfies the special nondiscrimination test (the ADP test).
g. Benefits, other than matching contributions, must not be contingent on an employee’s choosing or not choosing to have elective contributions made to the plan.

4.72.2.5.5 (03-01-2002)
Nonqualified CODAs

(1) A nonqualified CODA is one that fails to meet one or more of the requirements listed immediately above in IRM 4.72.2.5.4. The elective contributions in a nonqualified CODA are included in an employee’s gross income at the time the amount would have been (but for the cash or deferred election) included in the employee’s gross income.

(2) If the CODA is nonqualified because it is part of an ineligible plan (e.g., a defined benefit plan), then the entire plan is not qualified. However, if the nonqualified CODA is part of a plan that is permitted to include a CODA (e.g., a profit-sharing plan), then it’s possible, although unlikely, the entire plan may still satisfy IRC section 401(a). In such case, the elective contributions are treated and tested as employer nonelective contributions.

(3) A CODA that is intended to satisfy IRC section 401(k) but for some reason fails and becomes a nonqualified CODA will invariably violate the terms of the plan document and so cause the entire plan to be nonqualified.

4.72.2.5.6 (03-01-2002)
Examination Steps

(1) Review corporate documents or other enabling instruments to verify that the CODA was adopted and effective prior to any election taking effect.

(2) Determine whether the plan allows participants the right to elect to have contributions made to the plan in lieu of cash or some other taxable benefit. Also determine whether there is a pattern of allowing employees (including partners in a partnership plan) to elect, on a regular basis, into and out of plan participation in return for changes in compensation. This is a cash or deferred election unless it fits the one-time irrevocable election exception.

(3) Review W-2s and payroll records to verify that contributions are not designated or treated as after-tax employee contributions.

(4) If a CODA exists, determine whether the plan is eligible to include a CODA (e.g., a profit-sharing plan). If the plan is not eligible to include a CODA, the entire plan is not qualified.

(5) If the plan may have a CODA, determine whether the CODA is qualified or non-qualified. If non-qualified:

a. Check whether the ECs were reported as wages in the year withheld from compensation. Use IDRS search if necessary.
b. Check whether the plan satisfied the regular coverage and nondiscrimination rules of IRC sections 410(b) and 401(a)(4), rather than the special IRC section 401(k) coverage nondiscrimination rules, counting the ECs as employer contributions.

4.72.2.6 (03-01-2002)
Coverage and Participation

(1) The CODA portion of the plan, by itself, must satisfy one of the coverage tests under 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, uses the same testing method (prior year or current year) and may be permissively aggregated under the IRC section 410(b) regulations, but may not be aggregated with any non-CODA.

(2) In a CODA, each employee who is eligible to make an EC (an “eligible employee”) is treated as “benefiting,” (i.e., covered), regardless of whether the employee elects to have deferrals made to the plan. The term “eligible employee” also includes certain employees who are temporarily prohibited under the plan from making deferrals, such as a suspension following a hardship distribution. See the discussion later under “ADP Test.”

(3) Reg. 1.401 (a)(4)–11(g)(3) provides that section 401(k) and section 401(m) plans may be retroactively amended to extend eligibility to employees for coverage purposes within 10½ months after the plan year in which there is a coverage problem. Under this regulation, if a CODA needs to add some nonhighly compensated employees to satisfy IRC section 410(b), the employer must make a QNEC contribution to each of the added employees equal to the average of the ADRs of the nonhighly compensated employees who were eligible. This retroactive correction feature cannot be used to correct other defects, such as a failure to satisfy the ADP test.

(4) IRC section 401(k)(2)(D) provides that a CODA may not have a minimum service requirement for participation that is greater than 1 year. The general rules under IRC section 410(b) (up to 2 years if immediate vesting) apply for other contributions, such as matching contributions or QNECs.

(5) Employees covered by a collective bargaining agreement must be disaggregated from employees not covered by a collective bargaining

agreement for purposes of the ADP test. Separate collective bargaining units within the same plan may be disaggregated, but are not required to be, for purposes of the ADP test. The combination of bargaining units used for testing must be reasonable and reasonably consistent from year to year. Equivalent rules apply to multi-employer plans.

(6) An ESOP must be disaggregated from a CODA in the same plan. Even if an employer maintains CODAs in both an ESOP and another plan and an HCE participates in both, the CODAs are not aggregated.

4.72.2.6.1 (03-01-2002)

Examples

(1) The plan document contains language stating that only employees of division A are eligible for participation in the section 401(k) plan. The only other division of the employer is division B. The employees of these two divisions make up the total number of employees of the employer's workforce. Division A employs a total of 80 employees, 5 are highly compensated employees and 75 are nonhighly compensated employees. All employees of division A have satisfied the participation requirements for the section 401(k) plan. Division B employs 25 employees and all are nonhighly compensated employees. The plan benefits at least 70% of employees who are not highly compensated employees (75/75+25 or 75/100=75%) therefore, the plan passes coverage without having to use the average benefits test.

(2) Employer A maintains a plan which allows for elective contributions, matching contributions and employer discretionary profit-sharing contributions. Under the terms of the plan, all employees are eligible to make elective contributions and to receive matching contributions. The employer makes a matching contribution on behalf of all employees making elective contributions. In addition, the employer made a discretionary profit-sharing contribution equal to 5% of each employee's compensation. Under the disaggregation rules, each portion of the plan must be separately tested for coverage. In this case, the 401(k) portion satisfies coverage as 100% of all employees are benefiting. The 401(m) portion satisfies coverage as 100% of all employees are benefiting. The profit sharing portion satisfies the coverage rule as 100% of all employees are benefiting. All portions of the plan must satisfy coverage separately.

4.72.2.6.2 (03-01-2002)

Examination Steps

(1) Inspect the plan document and review the sections concerning eligibility. An employer can have separate eligibility requirements for ECs, matching contributions and discretionary contributions. Thus, review plan sections that define eligible employees and that specify age and service requirements and entry dates. A CODA cannot require that an employee complete more than 1 year of service in order to be eligible to make ECs.

(2) When testing the plan for coverage, the following records should be reviewed to determine proper inclusion or exclusion of employees. The

records for any related entities should be included in the review if the entity is a member of a controlled group or part of an affiliated service group.

a. Inspect the Form 5500 series return and extract the total number of employees of the employer, employees excluded and employees benefiting. Compare these numbers with the numbers from the employer's payroll records to determine if all employees have been accounted for on the return.
b. Inspect employer payroll records to extract the total employees, birth dates, hire dates, hours worked, union status and other pertinent information.
c. Inspect Form(s) W-2 and State Unemployment Tax Returns (compare the employees on these records with the employer's payroll records) to ensure all employees of the employer are counted for the coverage test.
d. Inspect participant election forms to verify the names of eligible employees who have elected not to have ECs made to the plan. These employees are considered as eligible employees with a zero percentage in the ADP calculations (and in the ACP calculations if no after-tax employee contributions are made). These employees also must be included for purposes of receiving an allocation of other, non-EC, employer contributions if they are otherwise eligible.
e. Inspect payroll records and extract the names of those employees who terminated employment during the year. Many plans will require an employee to be employed on the last day of the plan year in order to receive an allocation of an employer discretionary contribution. Any terminated employee with 500 or more hours of service must be included in the coverage test. Many small plans have a last-day requirement in their plans and can easily fail coverage because of it.
f. Inspect Schedule E, Compensation of Officers, of Form 1120 to gather names of officers and ownership percentages to help identify related entities.
g. Inspect any Form 851, Affiliation Schedule, attached to the Corporate Income Tax return to determine if there are any related entities.
h. Inspect a self-employed individual's Form 1040 Income tax return to determine whether there are any other entities operated and owned by the self-employed individual. Separate Schedule Cs, Profit or Loss from Business, should be filed for each business.
i. Inspect the plan document to determine whether the plan covers leased employees. If the employer has leased employees the plan may state that these employees are excluded, however, certain rules apply under IRC section 414(n) that may require the employer to include these leased employees for purposes of certain code sections, such as coverage and discrimination. Obtain contracts of the employer with any leasing organization and information/records for pension benefits received by the leased employee under the leasing organization's retirement plans.

(3) Ensure the plan passes either the ratio percentage test or the average benefits test under IRC section 410(b). For purposes of the coverage test

all employees of the employer must be considered, including all employees of entities that are part of a controlled group of corporations or affiliated service group that includes the employer. (See IRC section 1563(a) and the regulations thereunder for rules on aggregation of stock ownership for controlled group rules. See IRC section 414(m) and the regulations thereunder for rules pertaining to affiliated service groups.) There are three common forms of controlled groups: parent-subsidiary, brother-sister and combined groups.

(4) Ensure the plan includes leased employees if defined as eligible under the terms of the plan. Ensure that the plan passes coverage when leased employees are required to be included in the coverage test. Generally, the employer will have to include a leased employee in the test when the leased employee is performing services on a substantially full-time basis and when the total number of leased employees constitute more than 20% of the nonhighly compensated employee workforce of the employer. In these instances, these employees must be considered for the code sections noted under IRC section 414(n). However, an employer may include the benefits that the leased employee received from the leasing organization as being provided by the employer when testing for coverage.

4.72.2.7 (03-01-2002)

Contribution Limitation

(1) IRC section 402(g) provides that elective deferrals in excess of $7,000 (indexed for cost-of-living increases) for a year are included in the employee's gross income for the year and are included in gross income again when distributed from the plan. IRC section 402(g)(7). Deferrals in excess of the 402(g) limit are called "excess deferrals." To avoid double income inclusion of excess deferrals, an employee may inform an employer of the amount of excess deferrals in that employer's plan and request the return of them together with attributable earnings. (See Reg. 1.402(g)-1.) If returned by April 15 following the year of the excess, such deferrals will not be included in gross income when distributed. However, the employer is not required to honor such a request, although most plans do provide for such distributions. Indeed, if the employee is young, it may be cost effective to leave the excess deferrals in the plan: double income inclusion being outweighed by maybe 30 years of tax-free earnings. However, if the excess deferrals arose under plans of one employer, the employee cannot refuse a distribution. (See (3) and (4) below.) If excess deferrals are not distributed and are not disqualifying (i.e., they are made to plans of unrelated employers) they must remain in the plan until there is a permitted distributable event.

(2) IRC section 402(g) is applied to each employee, rather than to a plan, and for the employee's taxable year, which is nearly always the calendar year. Thus, it's possible that an employee can have deferrals to a plan equal to two times the 402(g) limit if the plan year is not the calendar year, although most are.

(3) IRC section 401(a)(30) provides that an employer's plan cannot accept elective contributions ("elective deferrals") from an employee in excess of the 402(g) limit, counting only plans of that employer. Thus, if an

employee defers more than the 402(g) limit, in the aggregate, spread among one or more plans maintained by the employer group, such plans are not qualified. For example, if an employee works for Company Y from January to June and then transfers to related Company Z for the next 6 months, his deferrals into Company Y's plan and into Company Z's plan for the calendar year are aggregated to determine whether the 402(g) limit has been exceeded. The plans will fail qualification if they accept excess deferrals. This limit must be stated in the plan.

(4) To avoid failing IRC section 401(a)(30), a plan must distribute excess deferrals and related earnings by April 15 following the year of the excess. In such case, affected employees are deemed to have requested a distribution.

(5) Excess deferrals that are timely distributed are still treated as employer contributions for most purposes of the Code, including the ADP test, but not IRC section 415. However, excess deferrals of nonhighly compensated employees that are timely distributed are not counted in the ADP test if they are prohibited by IRC section 401(a)(30). See Reg. 1.402(g)-1(e)(1)(ii).

(6) If an excess deferral is distributed before April 15, the distributing plan counts that distribution as an offset against any distribution of excess contributions that must be made to that employee to correct the ADP test.

(7) The 402(g) limit only applies to elective deferrals (i.e., elective contributions, in a section 401(k) plan); it does not affect other contributions that may be included in the ADP test. The amount of the 402(g) limit may be incorporated by reference.

4.72.2.7.1 (03-01-2002)
Example

(1) Employer A maintains a section 401(k) plan that allows participants to elect to defer up to a maximum of 15% of the their compensation for the plan year, which is a calendar year. During calendar year 1998, Participant B elects to defer 15% of her compensation for the year. Participant B, a highly compensated employee, received compensation during the year of $100,000. The total elective contributions made on behalf of Participant B for calendar year 1998 was $15,000. The IRC section 402(g) limit in effect for 1998 was $10,000, therefore, Participant B has an excess deferral in the amount of $5,000. Accordingly, the employer must distribute the excess, plus attributable earnings, by April 15, 1999, in order for the plan to remain qualified.

4.72.2.7.2 (03-01-2002)
Examination Steps

(1) Inspect the plan document to determine the maximum elective contributions that an employee can defer under the terms of the plan.

(2) When testing for compliance with the IRC section 402(g) limit in effect for the year, the following actions and inspection of records should be taken to ensure compliance.

a. Inspect Form W-2's for purposes of testing the plan for compliance with the IRC section 402(g) limit. The 402(g) limit is measured on the individual's tax year (calendar year) rather than the plan year.
b. Compare Form W-2 (Box #13 — coded "D," which indicates the amount that the individual deferred under the plan) with payroll records and account statements for reconciliation and accuracy of the deferred amounts reported.
c. Inspect all Form W-2s of each entity of a controlled group in order to ensure the limit has not been exceeded if an employee participates in more than one section 401(k) plan of the controlled group during the year. The IRC section 402(g) follows the individual and all deferrals must be aggregated to ensure compliance with this Code section and section 401(a)(30). It is not unusual for an employee in a mid-size or a large company to split time between the different companies that comprise a controlled group of corporations and that may have separate 401(k) plans. In these instances, the individual cannot defer more than the 402(g) limit to the employer's plans, therefore, the deferrals must be aggregated to determine whether the limit has been exceeded. Conduct an interview with your contact person to determine whether employees work for more than one company in the controlled group.
d. If a larger employer gives you payroll data on electronic media you may need to solicit the help of a Computer Audit Specialist (CAS). Usually the CAS can assist you in downloading the data to an Excel spreadsheet or Access Database. The CAS can also help in conducting the testing or queries for different limitations such as IRC section 402(g).
e. After testing the section 401(k) plan for IRC sections 402(g) and 401(a)(30), it is important to ensure that any excesses were properly and timely corrected by April 15th of the following year. Inspect Form 1099-Rs for distributions made to correct, and inspect cancelled checks to determine when the distribution was actually made.

4.72.2.8 (03-01-2002)

Restricted Distributions

(1) IRC section 401(k)(2)(B) provides the elective contributions may only be distributed on death, disability, separation from service, or an event described in IRC section 401(k)(10). Contributions made to a CODA that is part of a profit-sharing or stock bonus plan may be distributed upon attainment of age 59½. Distribution of any contribution that could be used in the ADP test (i.e., QNECs or QMACs) must be similarly restricted. Elective contributions (and grandfathered earnings, QNECs, QMACs and earnings on such QNECs and QMACs) to a profit-sharing or stock bonus plan may also be distributed on account of hardship.

(2) The events in IRC section 401(k)(10) are termination of the plan, disposition of corporate assets and sale of a subsidiary by the corporation maintaining the plan. To be distributable upon one of these events, the elective contributions must be distributed in a lump sum and, except for plan termination, the transferor corporation must continue to maintain the plan.

(3) Revenue Ruling 2000-27 provides that a separation from service can occur when an employer disposes of less than substantially all the assets of a trade or business. The notice describes circumstances involving sales and transfers of employees where a section 401(k) plan distribution may be made to such employees even though their working conditions have not changed.

4.72.2.8.1 (03-01-2002)
Plan Termination

(1) IRC section 401(k)(10)(A)(i) provides that a section 401(k) plan can make a distribution to employees if the plan is being terminated and the employer does not maintain or establish another defined contribution plan (other than an ESOP) within 12 months after all the assets are distributed from the terminated plan. A termination distribution can be made even if the employer maintains or establishes a SEP or SIMPLE IRA plan.

(2) Thus, generally, if any employer who is in the employer group at the effective date of the termination has a defined contribution plan (other than one listed above), the 401(k) plan assets must be transferred to that plan rather than distributed to the employees. However, distributions can be made if less than 2% of the employees of the terminating plan have been eligible or will become eligible for the other plan in the 12 months before and the 12 months after termination.

(3) In plans subject to the joint and survivor annuity rules, the lump-sum distribution requirement can be satisfied by the distribution of an immediate annuity that satisfies the qualified joint and survivor annuity requirements set forth in IRC section 401(a)(11) and IRC section 417.

4.72.2.8.2 (03-01-2002)
Sale of Subsidiary/Assets

(1) IRC section 401(k)(10)(A)(ii) allows distributions from a section 401(k) plan maintained by a corporation if the corporation sells at least 85% of the assets used in a trade or business to an unrelated corporation. Similarly, IRC section 401(k)(10)(A)(iii) allows distributions from a section 401(k) plan maintained by a corporation if the corporation disposes of its interest in a subsidiary. In either situation, a distribution may be made only to employees who continue employment with the employer that acquires the assets or subsidiary.

(2) For example, if a corporation maintains a section 401(k) plan for all of its employees, including those in a subsidiary, and the subsidiary is sold, any employee who stays with the subsidiary after the sale may receive a lump sum distribution from the plan. This distribution is only permitted if the purchasing company has not accepted a merger or transfer under IRC section 414(l) of any of the plan's assets or liabilities, or otherwise has taken over maintenance of part of the plan.

4.72.2.8.3 (03-01-2002)
Hardship Distribution

(1) A profit-sharing or stock bonus plan may provide that elective contributions are available for distribution on account of hardship. However, as a general rule, QNECs, QMACs and earnings on QNECs, QMACs and elective contributions may not be distributed on account of

hardship. The regulations permit a plan to provide a grandfather rule for earnings, QNECs and QMACs accrued prior to 12/31/88, (or, if later, the end of the last plan year ending before 7/1/89). This is done by determining an employee's elective contributions, QNECs and QMACs on the applicable date and using this as a frozen amount. Losses after that date do not reduce this amount.

(2) Note that other employer contributions, outside the CODA, are not subject to these restrictive hardship rules. Thus, a profit-sharing plan could have one set of rules for hardship distributions from the CODA and another, less restrictive, set of rules for other non-CODA contributions. Although most do, a CODA is not required to provide for hardship distributions at all.

(3) To make a hardship distribution the plan must determine if an employee:

a. has an immediate and heavy financial need, and
b. a distribution from the plan, of the specified amount, is necessary to satisfy the financial need.

(4) The determinations in a. and b. above can be made using either general hardship distribution standards or deemed hardship distribution standards, both as described in the 401(k) regulations. The majority of section 401(k) plans, including all M & P section 401(k) plans use the deemed standards. The determinations must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

(5) The amount necessary to satisfy an immediate and heavy financial need of the employee can be grossed up to cover any taxes or penalties that may result from the distribution

(6) Under Reg. 1.411(d)-4, a section 401(k) plan may not have a "catch-all" hardship category (for example, "and other events which the plan administrator deems to be hardships") because this would be impermissible employer discretion. The plan may be amended to add or eliminate a hardship category or to change the conditions for receiving a hardship distribution and this will not violate IRC section 411(d)(6). Hardship categories (general or deemed) must be both currently and effectively available to a group of participants that satisfies Reg. 1.401(a)(4)-4.

4.72.2.8.3.1 (03-01-2002)

General Hardship Distribution Standards

(1) Under the general hardship distribution standards, the determination of whether an employee has an immediate and heavy financial need is based on all the relevant facts and circumstances. Generally, for example, funeral expenses of a family member would qualify, whereas the need for a television would not.

(2) Under the general hardship distribution standards, a distribution is not treated as necessary to satisfy an immediate and heavy financial need of the employee to the extent the need can be satisfied from other resources that are reasonably available to the employee. The plan must

determine what other assets the employee has, such as, vacation homes, insurance policies, availability of loans from the plan or a bank (at reasonable rates), etc.

(3) The employer is permitted to rely on an employee's written statement that an amount is necessary (and cannot be satisfied by other means that are reasonably available to the employee), unless the employer has actual knowledge to the contrary.

(4) A loan from a commercial source or a loan from the plan (if otherwise available) can be ruled out unless the full amount can be reasonably obtained from either. However, a plan may permit a combination of a plan loan up to the limits of IRC section 72(p) and a hardship distribution which together are sufficient to satisfy the financial need.

4.72.2.8.3.2 (03-01-2002)

Deemed Hardship Distribution Standards

(1) Under the deemed hardship distribution standards, a distribution is deemed to be on account of an immediate and heavy financial need of the employee if it is for any of the following:

a. Medical expenses (as the term is defined in IRC section 213 but without regard to the AGI limit) incurred by the employee, spouse or dependant, to the extent not reimbursed by insurance. A distribution necessary to pay for procedures that have not yet occurred is permitted.
b. The purchase of a primary residence for the employee. (This does not include making mortgage payments.)
c. Post-secondary school tuition and tuition-like fees (e.g., lab fees) for the next 12 months.
d. The prevention of eviction or foreclosure from the employee's principal residence.

(2) Under the deemed hardship distribution standards, a distribution is deemed necessary to satisfy an immediate and heavy financial need of the employee if all of the following occur:

a. The distribution is not in excess of the amount needed.
b. The employee has obtained all distributions and nontaxable loans currently available under all plans maintained by the employer.
c. All plans of the employer limit the employee's elective contributions for the next year to the 402(g) limit for that year minus the employee's elective contributions for the year of the hardship distribution.
d. The employee is prohibited from making elective contributions and employee contributions to any plan of the employer for at least 12 months after receiving the distribution.

4.72.2.8.4 (03-01-2002)

Example

(1) Employer A maintains a section 401(k) plan that provides for hardship distributions under the deemed standards. The plan document contains language permitting participant loans. In 1999, Participant B submits an application requesting a hardship distribution of $2,000 in order to make a

downpayment on a principal residence. At the time of the hardship distribution request, Participant B had an account balance of $50,000 and he did not have any outstanding loans from the plan. The plan administrator approved the hardship distribution request and made a distribution of $2,000.

(2) The hardship distribution should not have been approved because Participant B should have received a nontaxable loan from the plan before any hardship distributions were made.

4.72.2.8.5 (03-01-2002)
Examination Steps

(1) Inspect the language in the plan document to determine when and under what circumstances distributions can be made.

(2) Inspect the language in the plan document to determine if hardship distributions are allowed and under what circumstances (general or deemed standards).

(3) Examine the plan document provisions pertaining to allowable distributions. If the plan provides for QNECs and QMACs, then these contributions are subject to the same restrictions as elective contributions, except that they generally cannot be distributed on account of hardship.

(4) When hardship distributions are made from the plan, compare the amount distributed with the total elective contributions made by the participant to the plan to ensure the distribution was not in excess of total elective contributions. Participant account statements should provide a separate breakdown of the elective contributions from other types of contributions.

(5) Request from the Plan Administrator copies of hardship application files. Inspect these files to determine the reason the distribution was made.

(6) If the plan uses the deemed hardship distribution standards, inspect the employee’s individual account statement for the 12 months following the receipt of the hardship distribution. The employee must be prohibited from making elective contributions (and after-tax employee contributions) for at least 12 months following receipt of the hardship distribution.

(7) Inspect the plan document to determine whether loans are available. If the plan provides for loans, then all nontaxable loans should be made prior to making any hardship distributions.

(8) A distribution generally may be treated as necessary to satisfy a financial need if the employer relies upon the employee’s written representation, unless the employer has actual knowledge that the need can be reasonable relieved through reimbursement from insurance, by liquidation of the employee’s assets, by cessation of elective contributions, or by other distributions or nontaxable loans from plans maintained by the employer. Interviewing the plan administrator may be necessary to determine the facts and circumstances surrounding questionable distributions.

(9) Request copies of Form 1099-Rs for all distributions including hardship distributions. The hardship distribution amount may be increased for federal, state and local taxes.

(10) If the CODA has been terminated, determine whether the employer had another defined contribution plan in existence at the time of termination or established one in the 12 months following distribution of all the assets from the terminating plan. If so, the CODA is not qualified unless the assets are transferred to the other defined contribution plan or the 2% overlap rule is satisfied.

4.72.2.9 (03-01-2002)
Nonforfeitability

(1) Under IRC sections 401(k)(2)(C) and 401(k)(3)(D)(ii), an employee's interest in elective contributions, QNECs, and QMACs must be nonforfeitable when made. Thus, an employer may not redesignate a particular contribution as a nonforfeitable contribution and call it a QNEC as needed to satisfy the ADP test for a year.

(2) However, an exception to this nonforfeitability rule is provided in IRC sections 401(k)(8)(E) and 411(a)(3)(G), which allows a plan to forfeit a vested or non-vested matching contribution made on account of an elective contribution or employee contribution that is treated as an excess deferral, an excess contribution (amounts in excess of what is permitted under the ADP test) or an excess aggregate contribution (amounts in excess of what is permitted under the ACP test).

(3) Under Reg. 1.401(a)(4)-4, a matching contribution that is still in the plan and that was matched to an excess contribution (or an excess aggregate contribution) that has been distributed (sometimes called "orphan matches") causes the plan to have a higher rate of match, when compared to the matched contributions remaining in the plan. This is most likely to be discriminatory because only highly compensated employees get the higher rate of match, since only highly compensated employees can have excess contributions. If this matching contribution is not required to be distributed as an excess aggregate contribution under the ACP test, it should be forfeited. It cannot be distributed, because there is no mechanism for distributing amounts that fail the Reg. 1.401(a)(4)-4 availability test, Of course, an amount may only be forfeited if the plan has a provision allowing such a forfeiture.

4.72.2.9.1 (03-01-2002)
Examination Steps

(1) Verify that any amounts used to satisfy the ADP test (ECs, QNECs, and QMACs) are 100% vested at all times.

(2) Check that matching contributions that relate to corrective distributions of elective or employee contributions to satisfy the ADP or ACP test are forfeited (or distributed, if necessary to satisfy the ACP test).

4.72.2.10 (03-01-2002)

CODA Nondiscrimination

(1) Under IRC section 401(k)(3), an employer maintaining a section 401(k) plan must annually compare the elective contributions of eligible highly compensated employees (“HCEs”) with those made by eligible nonhighly compensated employees (“NHCEs”) and, if certain limits are exceeded by the HCEs, must take corrective action to bring the plan within the limits. This testing for nondiscrimination (the ADP test) is the exclusive nondiscrimination test for amounts contributed to a CODA, that is, this test is used instead of any amounts test under IRC section 401(a)(4). QNECs and QMACs that are treated as elective contributions are also counted in the ADP test.

(2) The ADP test and its correction mechanisms can be costly for employers, so Congress enacted two alternatives to the ADP test:

a. For plan years beginning after December 31, 1996, employers could adopt SIMPLE 401(k) plans, modeled after SIMPLE IRA plans described in IRC section 408(p). See IRC sections 401(k)(11) and 401(m)(10).
b. For plan years beginning after December 31, 1998, employers could adopt safe harbor 401(k) plans described in IRC sections 401(k)(12) and 401(m)(11).

(3) Although a CODA must satisfy the ADP test (or be deemed to satisfy the ADP test because the CODA is part of a SIMPLE 401(k) plan or a safe harbor 401(k) plan) with respect to the amount of elective contributions, the right to make each level of elective contributions under a CODA is a benefit, right or feature that must satisfy the nondiscriminatory availability requirement of Regs. 1.401(a)(4)-4(e)(3).

(4) In addition to the ADP test, if an employer has one or more HCEs who are eligible under both a CODA of the employer that is subject to the ADP test and a plan of the employer that is subject to the ACP test, then the employer must perform an additional nondiscrimination test designed to limit the multiple use of the “2 plus or 2 times” prong of the ADP and ACP tests. This test is often referred to as the “multiple use test” and the “2 plus or 2 times” prong is referred to as the “alternative limitation.” Of course, if the alternative limitation is not used twice (or more), then the multiple use test need not be performed.

(5) The employer is required to maintain records necessary to demonstrate compliance with the CODA nondiscrimination requirements, including the extent to which QNECs and QMACs are taken into account.

4.72.2.10.1 (03-01-2002)

ADP Test

(1) Under the ADP test, set forth at IRC section 401(k)(3)(A)(ii), the ADP of the eligible HCEs cannot exceed the greater of:

a. 1.25 x the ADP of the eligible NHCEs, or
b. the lesser of 2 + the ADP of the eligible NHCEs or 2 X the ADP of the eligible NHCEs.

(2) The ADP for a group (either HCE or NHCE) is the average of the individual ADRs of the particular group. An eligible employee’s ADR is the

sum of the elective contributions and QNECs and QMACs that are treated as elective contributions allocated to the employee's account in the plan divided by the employee's compensation. ADRs and ADPs, expressed as a percentage, must be rounded to the nearest one-hundredth of a percent. If the only eligible employees under the CODA are HCEs, the plan automatically passes the ADP test.

(3) Only "eligible employees" are included in the ADP test. ("Eligible employees" are also counted as "benefiting" for purposes of satisfying the IRC section 410(b) coverage requirements.) An "eligible employee" is one who is eligible under the plan to make an elective contribution, whether or not the employee actually makes any deferrals. If an eligible employee chooses not to make elective contributions, and no QNECs or QMACs are made under the CODA, the employee must be included in the ADP test with an ADR of zero. The term also includes an employee who:

a. must perform purely ministerial or mechanical acts in order to make an elective contribution,
b. chooses not to make a mandatory after-tax employee contribution in a plan requiring after-tax contributions as a prerequisite to CODA participation,
c. has been suspended from making elective contributions under the plan (e.g., for having taken a hardship distribution), or
d. may not receive additional contributions because of the limits imposed by IRC section 415(c) (and IRC section 415(e) for limitation years before 2000).

(4) An employee who cannot make elective contributions because he or she was given a one-time election when the employee commenced employment with the employer or upon first becoming eligible under any CODA of the employer and elected not to be eligible to make elective contributions for the duration of employment with the employer is not an eligible employee.

(5) The ADP test is performed on the plan level, so identification of the "plan" is the first step to be performed. See the discussion under "Coverage and Participation" above. If a plan contains more than one CODA, the CODAs must be aggregated for purposes of the ADP test.

(6) If a plan is disaggregated into separate plans for purposes of IRC section 410(b), the CODA must also be disaggregated. For example, if a plan covers all employees, but, for testing purposes the plan is disaggregated into two plans, one covering employees who have less than 1 year of service or are less than age 21, and one covering all other employees, the employer would run two ADP tests, one for the employees with less than 1 year of service or less than age 21, and the other for all other employees.

(7) 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 1 year of service and reached age 21, provided the plan separately satisfies the minimum coverage rules of IRC section 410(b) taking into account only those employees who have not completed 1 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.

(8) If an HCE is eligible to participate in more than one CODA maintained by the same employer, the HCE's elective contributions under all of the employer's CODAs must be combined to determine the HCE's ADR. This combination ADR is then used in the ADP test under each CODA.

(9) The compensation used to calculate ADRs is limited to the IRC section 401(a)(17) amount and must also satisfy IRC section 414(s). The definition of compensation used by the CODA must be nondiscriminatory, and elective deferrals may be included or excluded from the definition.

(10) Contributions on behalf of HCEs that exceed the limits imposed by the ADP test are called excess contributions, that is, they 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. A plan must dispose of excess contributions by distributing them to certain HCEs or recharacterizing them as employee after-tax contributions. QNECs and QMACs contributed on behalf of NHCEs can be used to raise the NHCE ADP, thereby reducing or eliminating HCE contributions that might otherwise become excess contributions.

(11) Prior to 1997, the HCE ADP was compared to the NHCE ADP for the same plan year (the "testing year"). For plan years beginning after December 31, 1996, a plan can choose, by specifying in the plan document, whether it will perform the ADP test by comparing the HCE ADP with the same year's NHCE ADP ("current year testing") or by comparing the HCE ADP for a testing year with the prior plan year's NHCE ADP ("prior year testing").

4.72.2.10.1.1 (03-01-2002)

Current Year Testing

(1) In current year testing, the employer may not know for certain how much HCEs can defer for a particular plan year until the plan year is over, and by then it may be too late to have prevented excess contributions from arising. In calendar-year section 401(k) plans, the ADP test is usually performed around the end of January when the plan administrator receives all the necessary demographic and financial information.

(2) Elective contributions of an employee are taken into account for a plan year in current year ADP testing only if they are allocated to the employee's account as of a date within that plan year and are paid to the trust no later than 12 months after the end of the plan year to which the

contributions relate. (Note that under Department of Labor regulations, elective contributions must be paid into the trust by the earliest date such contributions can reasonably be segregated from the employer's general assets. See DOL Regs. 2510.3-102.) Further, the contributions must relate to compensation that, but for the employee's election to defer, would have been received by the employee in the plan year, or would have been received within 2½ months after the plan year if the compensation is attributable to services performed in the plan year.

(3) Under IRC section 401(k)(3)(D), an employer may take into account QNECs and QMACs in calculating the ADP, but, in order to do so, the regulations provide that such contributions must satisfy the nonforfeitability requirement, the distribution limitations and the 12-month contribution-to-the-trust rule that apply to elective contributions. In addition, QNECs, both before and after some or all are used in the ADP test, must satisfy IRC section 401(a)(4).

(4) Note that QNECs and QMACs made after the tax return filing date are not deductible for the prior taxable year. These contributions are counted, with other employer contributions, against the IRC section 404 deduction limits for the year made.

(5) QNECs or QMACs that are used in the ACP test cannot be used in the ADP test.

4.72.2.10.1.2 (03-01-2002)

Prior Year Testing

(1) Generally, the rules that apply to calculating ADRs and ADPs in current year testing also apply to prior year testing. Prior year testing simplifies plan administration because an employer can determine the percentage of elective contributions that can be made on behalf of HCEs early in the plan year and have more time to plan for correction. Consider the following examples:

a. 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.
b. Same facts as above, 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.

(2) The eligible employees taken into account in determining the prior year's ADP for NHCEs are those eligible employees who were NHCEs during the preceding year, without regard to the employee's status in the testing 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 for NHCEs for the preceding plan year is deemed to be 3 percent, unless an election is made to use the actual ADP data for the first plan year.

(3) ***Example:*** 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.

(4) 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 § IX of Notice 98-1.

4.72.2.10.1.2.1 (03-01-2002)

Use of QNECs and QMACs in Prior Year Testing

(1) To be taken into account for the NHCE ADP 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.

(2) ***Example:*** 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.

(3) Note that this 12-month rule does not change the rule under IRC 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 IRC section 404(a)(6) period applicable to the taxable year with or within which the particular limitation year ends. See Regs. 1.415-6(b)(7)(ii).

4.72.2.10.1.2.2 (03-01-2002)

First-Year Rule for Prior Year Testing

(1) 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 IRC 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).

(2) For ADP testing purposes, the “first plan year” is the first year in which the plan provides for elective contributions. A plan does not have a first plan year if for that year it is aggregated under the regulations with any other plan that provided for elective contributions in the prior year.

(3) 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 maintained by the employer in the prior year.

4.72.2.10.1.2.3 (03-01-2002)

Changes in the Group of NHCEs in Prior Year Testing

(1) In general, under the prior year testing method, subsequent changes in the group of NHCEs are disregarded. That is, the ADP 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.

(2) 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. A “plan coverage change” is a change in the group(s) of eligible employees on account of:

a. the establishment or amendment of a plan;
b. a plan merger, consolidation, or spinoff under IRC section 414(l);
c. a change in the way plans are (or are not) permissively aggregated under Regs. 1.410(b)-7(d); or
d. any combination of the above.

(3) A “prior year subgroup” is all NHCEs for the prior year who were eligible employees under a specific CODA 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.

(4) The “weighted average of the ADPs for the prior year subgroups” is the sum, for all prior year subgroups of the “adjusted ADPs.”

(5) The “adjusted ADP” for each prior year subgroup is the ADP 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.

(6) 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 for NHCEs of the plan that included that single prior year subgroup. Notice 98-1 contains examples involving plan coverage changes.

4.72.2.10.1.3 (03-01-2002)

Changing Testing Method

(1) 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.

(2) 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:

a. 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).
b. 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).
c. A transaction occurs that is described in IRC section 410(b)(6)(C)(i) (i.e., the employer becomes or ceases to be a member of an IRC 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 IRC section 410(b)(6)(C)(ii) (i.e., by the last day of the 1st plan year beginning after the transaction).
d. 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).

4.72.2.10.1.4 (03-01-2002)

Limits on Double Counting of Certain Contributions

(1) 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, elective contributions 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. To limit double counting, Notice 98-1 provides that the ADP for NHCEs for the prior year is determined taking into account only:

a. elective contributions 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.

(2) Thus, the following contributions made for the prior year are disregarded for the ADP test: QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year, elective contributions taken into account for purposes of the ACP test, and all QMACs.

(3) 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.

4.72.2.10.1.5 (03-01-2002)

Plan Provisions Regarding Testing Method

(1) 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.

(2) The regulations under IRC section 401(k) and (m) permit a plan to incorporate by reference IRC 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.

(3) 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).

4.72.2.10.1.6 (03-01-2002)

Correction of ADP Test

(1) If corrective QNECs or QMACs (for CODAs using current year testing) do not bring the CODA within the ADP limits, the plan must either distribute the excess contributions, along with attributable earnings, or recharacterize them as after-tax employee contributions, according to the terms of the plan. A plan may provide for more than one correction method or may provide for a combination of methods.

(2) If the ADP test is not corrected within the 12-month period following the end of the failed plan year, the CODA is not qualified and the plan may be disqualified. Failure to correct excess contributions will result in the CODA being nonqualified not only for the plan year for which the excess contributions were made but also all subsequent plan years during which the excess contributions remain in the trust.

4.72.2.10.1.6.1 (03-01-2002)
Determination of Excess Contributions

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

(2) ***Example:*** 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.

4.72.2.10.1.6.2 (03-01-2002)
Distribution of Excess Contributions

(1) For plan years beginning before January 1, 1997, corrective distributions of excess contributions, adjusted for earnings, were made to the HCEs whose ADRs were used to determine the amount of excess contributions and in the same amount. So in the previous example, $2,000 (adjusted for earnings) would be distributed to HCE1 and $500 (adjusted for earnings) to HCE2.

(2) Section 1433(e) of SBJPA amended IRC sections 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 are distributed to HCEs who have the largest amount of contributions in the numerator of their ADR (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 the previous example, 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. See Notice 97-2 for a more detailed example involving corrective distributions.

(3) A plan must distribute both the excess contribution and the earnings attributable to the excess contribution. Any reasonable method of determining income or loss otherwise used by the plan may be used to determine income or loss attributable to excess contributions. The regulations do not require the plan to determine or pay out the "gap

period" earnings (i.e., the earnings for the period from the end of the plan year to the distribution date). However, if a plan does provide for distribution of gap period earnings, the method used must be consistent for all participants and must be either the method the plan normally uses to allocate income to participants' accounts or the safe harbor method provided in the regulations.

(4) A failed ADP test can be corrected by distributing excess 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.

(5) 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.

(6) 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).

(7) Excess contributions distributable to a HCE for a plan year are reduced by the amount of any excess deferrals (amounts over the IRC section 402(g) limit) that have been distributed to the HCE for the HCE's tax year that ends with or within the plan year.

(8) Distributions of excess contributions and attributable earnings must be reported on Form 1099-R using the appropriate code. Such distributions are taxable distributions under IRC section 72, but are not subject to the consent rules under IRC sections 411(a)(11) and 417 or the early withdrawal tax under IRC section 72(t). The distributions must be immediately subject to income tax, so a "distribution" of the excess contributions into a nonqualified deferred compensation arrangement is not a permissible method of correction.

(9) If the distributions are made within the first 2½ months following the end of the plan year, the distributed amounts are treated (for income tax purposes) as if they were received by the employee as of the earliest date the employee could have received the amount in cash. In most cases, this means the distributions will be taxable in the preceding calendar year. If the distributions are made after the first 2½ months, the distributions are taxable in the year distributed (and the employer is subject to the 10% tax under IRC section 4979 tax). However, under IRC section 4979(f)(2)(B), if the total excess contributions and any excess aggregate contributions are less than $100 (without regard to attributable earnings), the amount is included in gross income in the year distributed even if the distribution is made in the 2½ month period.

4.72.2.10.1.6.3 (03-01-2002)
Recharacterization of Excess Contributions

(1) Under IRC section 401(k)(8)(A)(ii), a CODA can correct an excess contribution by "recharacterizing" an employee's excess contributions as an employee after-tax contribution. This is a fiction in which the plan is deemed to have distributed the excess contribution and the HCE is deemed to have contributed this amount to the plan as an after-tax employee contribution.

(2) The total amount of excess contributions and the HCEs to whom they are allocated is determined in the same manner as for distributions of excess contributions, except the amount recharacterized does not include attributable earnings.

(3) Plans may only recharacterize excess contributions within the first 2½ months after the plan year during which the excess arose, and then only if the plan otherwise allows for employee after-tax contributions.

(4) The employer or plan administrator must notify the HCEs to whom the excess contributions are allocated that the excess contributions are being recharacterized and must inform them of the tax consequences of the recharacterization. The date of the recharacterization (used to determine whether the 2½ month rule has been satisfied) is the date on which the last affected HCE receives notification.

(5) Excess contributions that are recharacterized are reported and appropriately coded on Form 1099-R and are included in gross income according to the same rules that apply for actual distributions of excess contributions.

(6) Once an amount has been recharacterized, it will be considered an employee contribution subject to the ACP test. However, for all other qualification purposes, such as deductibility under IRC section 404, the recharacterized amount continues to be considered an employer contribution.

(7) The plan may require recharacterization of excess contributions or may allow affected HCEs to choose between recharacterization and distribution.

4.72.2.10.1.7 (03-01-2002)
IRC section 4979 Tax

(1) IRC section 4979 imposes a tax on the employer equal to 10% of any excess contributions not corrected within 2½ months after the end of the plan year to which they relate. However, the tax does not apply if corrective QNECs or QMACs (current year testing plans only) are made within 12 months after the end of the plan year. If the QNECs or QMACs were insufficient to fully satisfy the ADP test, the tax will apply to the remaining excess contributions.

(2) The plan has 12 months after the end of the plan year being tested to correct excess contributions. The plan can distribute excess contributions any time during the 12-month period, but the employer will still be subject to the 10% tax if the distribution is made after the 2½-month period.

(3) The tax is reported on Form 5330 and is due 15 months after the end of the plan year. See Reg. 54.4979-1. Any extension of time to pay the tax is not an extension of time to correct the ADP test.

(4) The tax is a one-time tax, meaning, if excess contributions are not timely corrected for a plan year, the tax applies only for that year.

4.72.2.10.1.8 (03-01-2002)
Examination Steps

(1) Review the plan language to identify eligibility requirements and ensure that the plan is operating in accordance with the plan document.

(2) Review plan financial audit reports and corporate minutes for comments relating to eligibility provisions.

(3) Review plan financial audit reports and corporate minutes for comments on ADP testing and correction.

(4) Have the plan administrator explain policy/procedures for ADP/ACP/402(g) testing (including correction). Analyze the testing methodology and results confirming the accuracy of each ADP test.

(5) If the plan used a safe harbor method to satisfy the ADP/ACP tests, review the plan language and verify the employer made matching contributions or nonelective contribution that satisfied the safe harbor requirements. Also verify that the notice requirements were met.

(6) Establish that all employees who are eligible under the plan to make ECs are counted in the ADP test, even if some do not make ECs.

a. Check the overall group of eligible employees to determine whether those who have satisfied the plan's age and service requirements are allowed to make deferrals. Also ask if any other benefits are contingent on a contribution to the CODA.
b. Determine whether employees who are eligible to make a deferral but cannot because they have been suspended from making deferrals (e.g. because of receiving a hardship distribution), and who are allocated no QNECs or QMACs that are treated as ECs, have been included as "eligible" with a deferral percentage of "0" when running the ADP test.

(7) Compare the total number or eligible employees (including those who would be eligible but for a plan provision requiring a ministerial or mechanical act) with the number of employees used to run the ADP test. They should be the same.

(8) Examine payroll records, Forms W-2, time cards and personnel records, to verify employee compensation. If the plan year is not a calendar year, review the plan document to determine which period should be used and verify the operation of those provisions. If the employer limits compensation to the portion of the year in which the employee was eligible, verify that the plan's terms allow for such limitation and examine employees with such limited compensation. If limited, the amount of compensation should be that earned since participation in the plan.

(9) Verify that all compensation figures are limited in accordance with IRC section 401(a)(17). If the plan is not a safe harbor plan, examine the ADP test to verify that each individual's ADR is calculated using the properly limited compensation.

Note: Compensation used in the ADP test can either include or exclude elective contributions deferred during the year. The definition of compensation in Reg. 1.414(s)-1 makes reference to IRC section 415(c)(3), which includes elective deferrals in compensation (IRC section 415(c)(3)(D)). However, Reg. 1.414(s)-1(c)(3) contains a safe harbor alternative definition of compensation that satisfies IRC section 414(s) and does not count deferred compensation.

(10) Reconcile the total participant deferral contributions shown on Form 5500, Schedule H or I, to the total deferral amount shown on the ADP test.

(11) Test check whether the highly compensated employee group was properly determined, using payroll and organization data. Verify that an employee was considered an HCE if he or she was a 5% owner during the year or preceding year, or had compensation above $80,000 (indexed) for the preceding year, and if the employer so elected, was in the top-paid group that year.

(12) If a plan is disaggregated under IRC section 410(b), make sure that the ADP test is also run separately on each disaggregated plan. Apply the aggregation and disaggregation rules of Reg. 1.410(b)-7, as modified by Reg. 1.401(k)-1(g)(11), to find the "plan" (or plans) so that the ADP and ACP tests (or safe harbor or SIMPLE rules) can be applied to the proper employees. Ensure only plans with the same PYE are aggregated, if otherwise permitted.

a. Review the plan document to determine the eligibility requirements for the CODA. If the eligibility requirements are less than 1 year of service and/or less than age 21, the nondiscrimination testing may be applied on a disaggregation basis. Separate tests may be run; one for employees with less than 1 year of service and less than age 21, and one for all other employees.
b. If the plan is an ESOP, the ESOP portion of the plan must be disaggregated from the CODA in the same plan. This is true even if any HCE participates in the CODA portion of the ESOP and a CODA of another plan maintained by the employer.
c. Determine if any employees of the employer are covered by a collective bargaining agreement. If so, these employees must be disaggregated from employees not covered by a collective bargaining agreement for purposes of the ADP test. Review any lists, which identify employees covered by a collective bargaining agreement, such as reports prepared for payment of union dues or payroll records showing union dues deductions. Compare these employees to the separate ADP testing for employees under the collective bargaining agreement.
d. While inspecting the 5500 returns for all plans, determine if any other plan maintained by the employer contains a CODA. If so, the plans

may be aggregated for purposes of the ADP testing, but only if they have the same plan year. If two or more plans are aggregated for the ADP test, they must also be aggregated for coverage and discrimination testing. Inquire of the employer which plans were aggregated, if any. Verify from payroll records whether employees counted for the coverage and discrimination testing are the same employees in the ADP test if the plans were aggregated.

(13) Determine if any HCE is participating in more than one plan, which contains a CODA. If yes, the elective contributions for each HCE must be combined for purposes of determining ADRs. This ADR is then used in the ADP test for all CODAs.

(14) Compare ADP calculations to compensation and deferral amounts shown on Forms W-2 (or payroll records if the plan year is a fiscal year). Trace the individual entries to source documents.

(15) Verify that the ADP test for each group (HCE and NHCE) has been properly determined and that the ADP test was satisfied in accordance with the plan provisions describing the testing method (current year or prior year).

(16) For ADP test failures, verify proper and timely correction. Consider:

a. Whether the correction method was specified in the plan document and whether the method was foflowed; and
b. Whether the amount of excess contributions was calculated using the correct leveling procedure.

(17) For correction by distribution:

a. Inspect cancelled checks or trust statements to determine the date of distribution of the excess contributions (plus attributable earnings).
b. Inspect Form(s) 1099-R issued for distribution of excess contributions. Amounts distributed should include any gains or losses. For distributions made within the 2½ month period following the plan year end, the distribution is includible in income for the employee's taxable year in which the excess occurred. Distributions made to an employee after 2½ months or that are less than $100 (not counting earnings) are includible in income for the employee's taxable year in which the distribution was made.
c. If the distribution was made after 2½ months following the end of the plan year in which the excess arose, the IRC section 4979 tax applies. Inspect or solicit Form 5330 and verify remittance of the excise tax.

(18) If correction was by recharacterization, consider:

a. Recharacterization must occur within 2½ months following the end of the plan year in which the excess arose. Inspect recharacterization notices issued to HCEs. Recharacterization is "deemed" to have occurred on the date of the last notice.

b. Inspect Forms 1099-R to verify that recharacterized amounts were correctly reported. Earnings or losses on recharacterized amounts are not taxable and should not be included in the amount reported on the Form 1099-R.

(19) If correction was by contribution of QNECs and/or QMACs, determine whether the contributions were made within 1 year after PYE by inspecting cancelled checks or trust statements. (Note that this correction method is not available for plans using the prior year testing method.)

4.72.2.11 (03-01-2002)

SIMPLE 401(k) Plans

(1) IRC sections 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 beginning in 1997. SIMPLE 401(k) plans must be maintained on a calendar-year basis. A SIMPLE 401(k) plan is deemed to satisfy the ADP and ACP tests and is not subject to the top-heavy requirements. They closely follow the requirements for SIMPLE IRA plans described in IRC section 408(p), but SIMPLE IRA plans are far more popular with employers because the IRA plans are less burdensome to set up and maintain, for example, Form 5500s are not required for SIMPLE IRA plans.

(2) To set up a SIMPLE 401(k) plan, for the prior calendar year, an employer must have had no more than 100 employees making $5,000 or more. Also, no employee covered under the SIMPLE 401(k) plan can be covered under another plan of the employer.

(3) Elective contributions are limited to $6,000 (indexed) per year, and each year the employer must contribute either:

a. a matching contribution equal to the lesser of the employee's elective contribution or 3 percent of the employee's compensation, or
b. a nonelective contribution equal to 2 percent of each eligible employee's compensation for the year, but the plan can exclude from this contribution employees who did not earn $5,000 or more for the year.

(4) All contributions to the plan must be fully vested at all times and no contributions other than those described above can be made to the plan.

(5) A special, inclusive definition of compensation applies to SIMPLE 401(k) plans. See IRC section 408(p)(6). Basically, compensation is what is reported on an employee's Form W-2 for the year, including elective contributions. Also, compensation is limited to the IRC section 401(a)(17) amount ($150,000, as increased for cost of living).

(6) Each eligible employee must be given the opportunity to make or modify a deferral election during the 60-day period prior to each January 1. For the first time an employee becomes eligible, the first 60-day period can be any 60-day period that includes the date he or she becomes eligible or the day before.

(7) Prior to each election period, the employer must notify all eligible employees of their right to make deferral elections and whether the employer will be making a matching or nonelective contribution for the year.

(8) The Service issued guidance on SIMPLE 401(k) plans, including a model amendment, in Revenue Procedure 97-9.

4.72.2.12 (03-01-2002)
Safe Harbor 401(k) Plans

(1) Beginning in 1999, safe harbor 401(k) plans became available to employers. The Service has published two notices on safe harbor plans, Notice 98-52 and Notice 2000-3. These two notices provide guidance on the design-based alternative or “safe harbor” methods under IRC sections 401(k)(12) and 401(m)(11) for satisfying the ADP test and the ACP test under IRC sections 401(k) and 401(m). A safe harbor 401(k) plan is deemed to satisfy the ADP test (and usually the ACP test as well). If a CODA satisfies the rules in IRC section 401(k)(12) and also the rules in IRC section 401(m)(11), the plan is deemed to satisfy both the ADP test and the ACP test. A plan can satisfy the ADP safe harbor without satisfying the ACP safe harbor, but a plan cannot satisfy the ACP safe harbor without satisfying the ADP safe harbor.

(2) A plan that uses the safe harbor methods to satisfy the ADP or ACP test is treated as using the current year testing method for that plan year.

(3) Note that IRC sections 401(k)(12) and 401(m)(11) provide guidance on the contributions required for NHCEs, but a safe harbor plan will provide for uniform contribution formulas that apply to both NHCEs and HCEs.

(4) Notice 2000-3 provides guidance, in the form of 11 questions and answers, on the safe harbor methods. These Q&As are in section III of the notice, and they either modify Notice 98-52 or provide additional guidance on the safe harbors. Sections I and II of the notice explain the purpose of the notice, summarize the contents of the notice and provide background information.

4.72.2.12.1 (03-01-2002)
Plan Provisions for Safe Harbor Plans

(1) Generally, an employer that intends to use the safe harbor provisions for a plan year must adopt those provisions before the first day of that plan year. However, for the remedial amendment period, under Section 4 of Rev. Proc. 2000-27, 2000-26 I.R.B. 1272, a section 401(k) plan intending to take advantage of the safe harbor methods for the 1999, 2000 or 2001 plan year must generally be amended no later than the end of the 2001 plan year, retroactive to the first day of the 1999, 2000 or 20001 plan year, to reflect the first use of the safe harbor methods.

(2) Under Q&A-1 of Notice 2000-3, a section 401(k) plan can be amended as late as 30 days prior to the end of a plan year to provide for the use of the safe harbor nonelective contribution method for that plan year, provided that a regular safe harbor notice (with modified content) is given

to eligible employees before the beginning of the plan year and a supplemental notice is given no later than 30 days before the end of the plan year.

(3) Under Q&A-11 of Notice 2000-3, a profit-sharing plan that does not contain a CODA generally can be amended as late as 3 months prior to the end of a plan year to provide for the use of the ADP/ACP safe harbor methods for that plan year.

4.72.2.12.2 (03-01-2002)

Special Compensation Definition for Safe Harbor Plans

(1) Generally, the same definitions apply as are used in other CODAs. In the case of “compensation,” the same definition applies for purposes of determining employer nonelective contributions, thus, a uniform definition of compensation satisfying Regs. 1.414(s)-1 must be used for the ADP and ACP safe harbors for purposes of the basic and enhanced matching formulas, the nonelective contribution requirement and the matching contribution limitations. For example, a plan could use a definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation. (This is an IRC section 414(s) safe harbor definition of compensation. See section 1.414(s)-1(c)(2).)

(2) However, with respect to elective contributions under a plan using the ADP safe harbor matching formula, each eligible NHCE may make elective contributions under a “reasonable definition” of compensation as defined under Regs. 1.414(s)-1(d)(2). Such definition is not required to satisfy the nondiscrimination requirement of Regs. 1.414(s)-1(d)(3). However, the plan must permit each eligible NHCE to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions under the plan for the plan year and the employee must be permitted to elect any lesser amount of elective contributions.

(3) Compensation may not be limited to a specific dollar amount for NHCEs for purposes of the ADP and ACP safe harbors. (The last sentence in section 1.414(s)-1(d)(2)(iii) of the regulations does not apply.) Note that the annual compensation limit under section 401(a)(17) still applies.

(4) A plan can limit an employee’s compensation to the portion of the plan year in which the employee was an eligible employee under the plan, provided that this limit is applied uniformly to all eligible employees.

(5) Example (illustrating compensation): An employer’s section 401(k) plan defines compensation as “all salary, wages, bonuses, and other remuneration not exceeding $75,000.” The plan does not satisfy the ADP/ACP test safe harbors because the definition of compensation excludes compensation over $75,000.

(6) Example (illustrating compensation): An employer’s section 401(k) plan allows employees to make elective contributions only from basic compensation, defined as salary, regular time wages, bonuses and commissions, and excluding overtime pay. This is a reasonable definition

of compensation within the meaning of Regs. 1.414(s)-1(d)(2), but is not necessarily nondiscriminatory. The plan provides for a required matching contribution equal to 100 percent of each eligible employee's elective contributions, up to 4 percent of compensation. For purposes of the matching formula, compensation is defined as compensation under IRC section 415(c)(3). Under the plan, each NHCE who is an eligible employee is permitted to make elective contributions equal to at least 4 percent of the employee's compensation under IRC section 415(c)(3) (that is the amount of elective contributions sufficient to receive the maximum amount of matching contributions available under the plan). This plan's definitions of compensation satisfy the safe harbor rules.

4.72.2.12.3 (03-01-2002)

Requirements for Safe Harbor Matching and Safe Harbor Nonelective Contributions

(1) The plan must specify that the safe harbor matching and nonelective contributions are nonforfeitable when made and subject to the withdrawal restrictions of IRC section 401(k)(2)(B) (that is, such contributions and earnings cannot be distributed earlier than separation from service, death, disability, an event described in IRC section 401(k)(10), or age 59½ for a profit-sharing or stock bonus plan).

4.72.2.12.4 (03-01-2002)

ADP Test Safe Harbor Requirements

(1) To satisfy the ADP safe harbor, a CODA must satisfy the safe harbor contribution requirement and the notice requirement of IRC section 401(k)(12).

(2) The safe harbor contribution requirement is satisfied for a plan year if the plan satisfies either the matching contribution requirement or the nonelective contribution requirement. Safe harbor matching or safe harbor nonelective contributions, whichever is used, must be made on behalf of all eligible employees under the plan; meaning, for example, that the plan cannot restrict these contributions to employees employed on the last day of the plan year or to employees who have at least 1,000 hours of service in the plan year. The safe harbor contribution requirement must be satisfied without regard to the integration provisions of section 401(l).

(3) A plan may satisfy the matching contribution requirement by providing for either the basic matching formula or an enhanced matching formula.

a. The basic matching formula provides matching contributions on behalf of each eligible NHCE in an amount equal to 100 percent of the employee's elective contributions up to 3 percent of the employee's compensation, and 50 percent of the employee's elective contributions that exceed 3 percent of the employee's compensation but do not exceed 5 percent of the employee's compensation.
b. An enhanced matching formula provides matching contributions for each eligible NHCE under a formula that provides an aggregate amount of matching contributions at least equal to the aggregate amount that would have been provided under the basic matching

formula at any elective contribution rate, and the rate of matching contributions may not increase as an employee's rate of elective contributions increases.

(4) For example, a plan provides that matching contributions will be made at the following rates: 100 percent of an employee's elective contributions that do not exceed 2 percent of compensation and 75 percent of the employee's elective contributions that exceed 2 percent but do not exceed 5 percent of compensation. This formula does not satisfy the enhanced matching formula since the aggregate amount that is provided by this formula is not at least equal to the amount that would have been provided under the basic matching formula at all rates of elective contributions. Under the basic matching formula, matching contributions of 100 percent would be made on the amount of the employee's elective contributions that do not exceed 3 percent of compensation. Under the plan's formula, the amount of matching contributions at 3 percent is less than 100 percent. For additional examples, see the examples in section V.B.3. of Notice 98-52.

(5) Note that a plan that contains a formula that satisfies the ADP test safe harbor. will not fail the ADP test safe harbor because the plan also provides for discretionary matches. See below or section VI.B.4 of Notice 98-52 for the limitations on the amount of discretionary matches under the ACP test safe harbor.

(6) A matching formula does not satisfy the safe harbor if, at any rate of elective contributions, the rate of matching contributions for an eligible HCE is greater than the rate of matching contributions for an eligible NHCE at the same rate of elective contributions. For example, a plan covers Divisions A and B, both of which have NHCEs and HCEs. If the plan provides for a basic matching formula for Division A and an enhanced matching formula for Division B, (such as 100 percent match of each employee's elective contributions up to 4 percent of a Division B employee's section 415(c)(3) compensation), the rate of match for a Division B HCE at a rate of elective contributions of 4 percent is greater than the rate of match for a Division A NHCE at the same rate of elective contributions; therefore, the plan would not satisfy the ADP test safe harbor (see example 5 under section V.B.3 of Notice 98-52).

(7) Generally, the matching contribution requirement is not satisfied if elective contributions by NHCEs are restricted. However, the following restrictions on elective contributions are permitted:

a. certain reasonable limits on the periods during which employees can make or change their deferral elections;
b. certain limits on the amount of elective contributions that can be made, for example, an employer can require that elective contributions be made in whole percentages of pay or in whole dollar amounts;
c. certain limits on the types of compensation that may be deferred; and

d. limits on elective contributions to satisfy IRC section 402(g) or 415 or on account of suspensions due to hardship distributions or withdrawals of employee contributions.

(8) Despite all of the restrictions just described, there are certain conditions that must be satisfied. For example, as discussed earlier, although a plan sponsor may limit the amount of elective contributions, the employer must permit each eligible NHCE to make sufficient elective contributions to receive the maximum amount of matching contributions available under the plan. For an explanation of restrictions on types of compensation that may be deferred, see the definition of compensation above or section V.B.1.c.iii.

(9) Under Q&A-6 of Notice 2000-3, a safe harbor plan using matching contributions to satisfy the safe harbor contribution requirement can be amended during a plan year to prospectively reduce or eliminate matching contributions and instead use the current year testing method, provided certain notice and election requirements are satisfied.

(10) An alternative to the matching contribution requirement, that can also satisfy the safe harbor contribution requirement, is the nonelective contribution requirement. The nonelective contribution requirement is satisfied if, under the terms of the plan, the employer is required to make a safe harbor nonelective contribution on behalf of each eligible NHCE in an amount equal to at least 3 percent of the employee's compensation.

4.72.2.12.5 (03-01-2002)

Notice Requirement

(1) The second requirement necessary to satisfy the ADP test safe harbor is the notice requirement, which is satisfied if each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement of section V.C.1. of Notice 98-52 and the timing requirement of section V.C.2. of Notice 98-52, both sections as modified by Notice 2000-3.

(2) The content requirement requires that the notice must describe the safe harbor method in use, making elections, any other plans involved, etc. (with 1999 transition relief). See Q&As -7 and -8 of Notice 2000-3 for information on satisfying the content requirement using electronic media and referencing the plan's summary plan description.

(3) The timing requirement requires that the plan sponsor must provide notice within a reasonable period before each year. This requirement is deemed to be satisfied if the notice is given to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year (with special rules for employees who become eligible after such 90th day). Transition relief for 1999 and 2000 is provided.

(4) Under Q&A-1 of Notice 2000-3, the content requirement is modified for a section 401(k) plan that wants to reserve the option of using the safe harbor nonelective contribution method to satisfy the ADP/ACP test for a

plan year. Under Q&As -1 and -6 of Notice 2000-3, a supplemental notice (with special content requirements) may have to be given during the plan year.

4.72.2.12.6 (03-01-2002)
ACP Test Safe Harbor

(1) To satisfy the ACP test safe harbor with respect to matching contributions, a plan must satisfy the ADP test safe harbor and limit matching contributions in accordance with IRC section 401(m)(11).

(2) There are three ways to satisfy the matching contribution limitations of IRC section 401 (m)(11):

a. The plan can provide for the "basic matching formula," described above in the ADP test safe harbor, and for no other matching contributions.
b. The plan can provide for an "enhanced matching formula," described above in the ADP test safe harbor, but under which matching contributions are only made with respect to elective contributions that do not exceed 6 percent of the employee's compensation, and no other matching contributions are provided under the plan.
c. In the case of any other plan, the matching contribution limitations satisfy the ACP test safe harbor if matching contributions are not made with respect to elective contributions or employee contributions that in the aggregate exceed 6 percent of the employee's compensation, the rate of matching contributions does not increase as the rate of employee contributions or elective contributions increases, and for employees at the same rate of elective contributions or employee contributions, the rate of matching contributions for an HCE does not exceed the rate of matching contributions for an NHCE.

(3) The elective contributions or employee contributions that are used for determining the matching contributions may be restricted only as permitted under the rules for the ADP test safe harbor, above.

(4) A plan that provides for discretionary matches (in addition to nondiscretionary matches needed to satisfy the ADP test safe harbor) can satisfy the ACP test safe harbor if the discretionary matches in the aggregate do not exceed a dollar amount equal to 4 percent of the employee's compensation. This limitation on matching contributions made at the employer's discretion does not apply to plan years beginning before 1/1/2000.

(5) The ACP test (not the safe harbor) still applies to a plan with respect to employee contributions and matching contributions that fail to satisfy the ACP test safe harbor.

4.72.2.12.7 (03-01-2002)
Multiple CODAs and Multiple Plans

(1) ADP test safe harbor matching contributions or nonelective contributions may be made to the plan that contains the CODA or to another defined contribution plan that satisfies IRC section 401(a) or section 403(a). If safe harbor contributions are made to another defined contribution plan,

the safe harbor contribution requirement must be satisfied in the same manner as if the contributions were made to the plan that contains the CODA. Consequently, each employee eligible under the plan containing the CODA must be eligible under the same conditions under the other defined contribution plan (that is, both plans must have identical eligibility/participation requirements).

(2) In order for safe harbor contributions to be made to another defined contribution plan, that plan must have the same plan year as the plan containing the CODA. However, there is an exception for plans containing CODAs in the case of plan years beginning before 1/1/2000 if:

a. the safe harbor contribution is allocated as of a date within the plan year of the plan containing the CODA, and
b. the contribution is made no later than 12 months after the close of that plan year.

(3) The plan receiving the safe harbor contributions does not have to be capable of being aggregated with the plan containing the CODA for purposes of section 410(b).

(4) In addition, safe harbor matching or nonelective contributions cannot be used to satisfy the safe harbor contribution requirements with respect to more than one plan. Thus, these contributions can be used only once to satisfy the safe harbor requirement.

(5) The rules for aggregating and disaggregating CODAs and plans also apply for purposes of the ADP/ACP test safe harbor requirements. Thus, all CODAs included in a plan are treated as a single CODA that must satisfy the safe harbor contribution requirement and the notice requirement. Two plans (within the meaning of Regs. 1.410(b)-7(b)) that are treated as a single plan under permissive aggregation are treated as a single plan for purposes of the safe harbor methods. Conversely, a plan (within the meaning of IRC section 414(l)) that includes a CODA covering both collectively bargained employees and noncollectively bargained employees is treated as two separate plans for purposes of IRC section 401(k), and the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor.

(6) If an HCE is simultaneously an eligible employee under two plans maintained by an employer for a plan year, only one of which is intended to satisfy the ADP/ACP test using the safe harbor methods, and the matching contribution formula of the plan that is not using the safe harbor methods provides greater matching contributions than the formula under the plan that is intended to satisfy the ADP/ACP test using the safe harbor methods, the rules prohibiting an HCE from receiving a greater rate of matching contributions than an NHCE could be violated.

4.72.2.13 (03-01-2002)
Contingent Benefits

(1) An employer may not directly or indirectly condition another employer benefit (other than matching contributions) upon an employee's election to make or not make elective contributions. This includes benefits under a DB plan, nonelective employer contributions to a DC plan, benefits under a nonqualified plan, the right to make employee contributions, the right to health and life insurance, and the right to employment. If the employer has made an employer benefit conditioned upon elective contributions, the CODA is not qualified. This rule is in the statute to prevent employers from encouraging employees to make or not make elective contributions by linking valuable benefits to the contribution or lack of a contribution.

(2) Participation in a nonqualified plan is treated as a contingent benefit only to the extent an employee may receive additional deferred compensation under the nonqualified plan depending on the employee's making or not making elective contributions. However, participation in a nonqualified plan is not treated as a contingent benefit if an employee's participation is conditioned on making the maximum deferrals under IRC section 402(g) or the terms of the plan.

4.72.2.13.1 (03-01-2002)
Examination Steps

(1) Ask whether the employer ties any benefits other than matching contributions to elective contributions. In certain circumstances it may be appropriate to request an interview with employees who make or fail to make elective contributions to see if they get any special treatment from the employer.

(2) Determine whether there is a nonqualified plan linked with the CODA. If there is, ensure there are no conditions in the form or in the operation of the nonqualified plan that are dependent on participation, lack of participation, or reduced participation in the CODA.

4.72.2.14 (03-01-2002)
Cafeteria Plans

(1) IRC section 125 permits an employer to maintain a "cafeteria plan." A cafeteria plan allows an employee to select among various types of employer benefits by specifying where an employer contribution should be spent.

(2) Cafeteria plans are permitted to offer a contribution into a qualified CODA as one of the options, but if it does, another option in the cafeteria plan must be a cash payment to the employee equal to the amount contributed to the cafeteria plan.

4.72.2.14.1 (03-01-2002)
Examination Step

(1) Ask whether the employer has a cafeteria plan that allows a contribution to the CODA. Review the options available to the cafeteria plan participants to ensure that receiving cash is one of the listed options.

4.72.2.15 (03-01-2002)
Top-Heavy Rules

(1) CODAs (but not SIMPLE 401(k) plans) are subject to the top-heavy rules in IRC section 416. If a plan containing a CODA is top-heavy, then the plan must:

a. vest contributions that are not immediately fully vested at a certain minimum rate and
b. provide each nonkey employee who is employed on the last day of the plan year with a contribution equal to 3 percent of the employee's compensation for the entire year or, if lesser, the same percentage as the key employee with the highest percentage contribution. Thus, if the highest percentage contribution given to a key employee was 4 percent, then nonkey employees must each receive a 3-percent contribution. But if the key employee with the highest percentage contribution got a 2-percent contribution, then nonkey employees need only be given a 2-percent contribution.

(2) Elective contributions on behalf of key employees must be taken into account in determining the minimum contribution required for nonkey employees, but elective contributions of nonkey employees do not count towards satisfying the minimum contribution. Thus, if the only contributions made to a profit-sharing plan for a year were elective contributions and all participants, keys and nonkeys, made deferrals of 2 percent, then, if the plan was top-heavy, the employer would have to make a 2-percent contribution to the plan for all the nonkeys. See Regs. 1.416-1, M-20.

(3) Similarly, nonkey employee matching contributions used in the ACP test (and QMACs used in the ADP test) are not counted towards satisfying the nonkey minimum contribution. QNECs, however, whether or not used to satisfy the ADP test, can be used to satisfy the nonkey minimum contribution. See Regs. 1.416-1, M-18.

(4) If it is determined that the top-heavy minimums are provided in another plan, and the eligibility requirements are not the same for both plans, then eligible participants in the section 401(k) plan may not be receiving the minimum benefit in the other plan and therefore must receive a minimum benefit in the section 401(k) plan.

4.72.2.15.1 (03-01-2002)

Example

(1) An employer maintains a money purchase pension plan and a profit-sharing plan with a CODA. The money purchase plan requires 1 year of service for eligibility and provides a contribution of 10% of compensation to all eligible participants.

(2) The profit sharing plan also requires 1 year of service for the profit-sharing portion of the plan but requires only 3 months of service for the CODA portion. In this case, those employees who are eligible for the CODA portion of the plan who have not yet met the eligibility requirements of the money purchase pension plan, are entitled to a minimum top-heavy contribution in the CODA plan, if it's top-heavy.

(3) The minimum contribution required depends on the allocations to key employees in the CODA plan.

4.72.2.15.2 (03-01-2002)
Examination Steps

(1) Inspect the plan document to determine if the vesting schedule meets the requirements of IRC 416 and verify that the plan follows the schedule in operation.

(2) If another plan is maintained, determine which plan provides the top-heavy minimum benefit.

(3) Verify that all nonkey employees eligible to participate in the CODA who are employed on the last day of the plan year are receiving the top-heavy minimum benefit. If this benefit is provided in another plan, compare the allocation schedule to the list of eligible employees used for the ADP testing in the CODA plan. The list should include all employees who meet the eligibility requirements of the CODA including those who do not elect to contribute under the CODA. If discrepancies are noted, request a complete list of all employees employed on the last day of the plan year who met the eligibility requirements of the CODA. Inspect payroll or other employment records to verify information provided.

(4) Verify that all eligible nonkey employees under the plan are receiving an employer contribution of at least 3% of compensation, (or the highest contribution to any key employee, if less than 3%),

(5) If the employer has made QNECs for the plan year, they may be used to satisfy the top-heavy minimum contribution requirements even if they were used to satisfy the ADP test.

(6) QMACs used to satisfy the ADP test or the ACP test may not be used to satisfy the top-heavy minimum contribution requirements. If the QMAC's are used to satisfy the top-heavy minimum, they may not be counted as a matching contribution.

(7) Elective contributions of nonkey employees may not be counted to satisfy the top-heavy minimum contribution requirements. However, elective contributions made on behalf of key employees are counted to determine the percentage of compensation required under the top-heavy minimum contribution.

4.72.2.16 (03-01-2002)
IRC Section 415 Rules

(1) A plan can use a number of definitions of compensation for determining allocations (but only to the extent the definition is stated in the plan). However, for IRC section 415 purposes, a different definition may be needed.

(2) As previously noted, for limitation years beginning after 1997, IRC section 415(c)(3) was amended to provide that the definition of compensation includes elective contributions, IRC section 132(f)(4) elective amounts and deferrals made under section 125 and section 457 plans. Under IRC section 414(s), a plan can use a definition that excludes all of these types of contributions.

(3) Regs. 1.415-6(b)(6) was amended to provide that elective contributions that constitute excess annual additions may be distributed to an employee if the excess was due to certain errors, such as, a "reasonable

error in determining the amount of elective deferrals that may be made with respect to an individual under IRC section 415." Of course, the plan must have such correction language in the plan document. See Rev. Proc. 92-93, 1993-2 C.B. 505, for information on the correction method.

(4) If the plan distributes the elective contributions to correct an IRC section 415 problem, the ADP test may have to be run again for each year involved, since the amounts distributed under Regs. 1.415-6(b)(6)(iv) cannot be used in the ADP test. In addition, if the elective contribution distributed is tied to a matching contribution, the remaining matching contribution may be discriminatory if the employee receiving the distribution is a HCE. There is no mechanism for either forfeiting or distributing this discriminatory matching contribution, but Regs. 1.401(a)(4)-11(g)(3)(vii)(B) provides a method of correcting discriminatory matching contributions (if the problem is discovered and can be corrected within 10½ months after the end of the plan year).

4.72.2.16.1 (03-01-2002)
Examination Steps

(1) Review Form 5500, Schedule H or I, Item 2(f), for disclosure of distributions made to correct IRC section 415 excess annual additions.

(2) Review plan financial audit reports and corporate minutes for comments that address section 415 concerns.

(3) Check the W-2 information for IRC section 415 excess amounts.

(4) Determine whether the employer maintains more than one plan. If yes, verify that annual addition calculations reflect contributions made to all defined contribution plans and employee contributions to defined benefit plans maintained by the employer. Ensure that the elective deferrals to all IRC section 401(k) plans and similar arrangements and salary reduction contributions to cafeteria plans are included in compensation for purposes of IRC section 415 testing.

(5) Review the plan document for IRC section 415 limitation language and methods of correction of excess amounts. If there were IRC section 415 excesses during the year, verify that the correction method was proper and complied with the plan document. If the plan corrected an IRC section 415 problem by distributing elective contributions, determine whether the employer met the requirements for such correction (see Regs. 1.415-6(b)(6)), re-ran the ADP test without the distributed amounts, and whether there were any matching contributions tied to those distributed amounts.

(6) Check the plan definition of compensation for allocation or elective contribution purposes. If the definition does not satisfy IRC section 415, and the overall contribution levels or percentages are high, determine whether the 415 limits have been met using the IRC section 415 definition of compensation.

4.72.2.17 (03-01-2002)

Annual Statutory Limits Applicable to CODAs

Year	402(g)	401(a)(17)	414(q)	415(c)	TWB
2001	10,500	170,000	85,000	35,000	80,400
2000	10,500	170,000	85,000	30,000	76,200
1999	10,000	160,000	80,000	30,000	72,600
1998	10,000	160,000	80,000	30,000	68,400
1997	9,500	160,000		30,000	65,400
1996	9,500	150,000		30,000	62,700
1995	9,240	150,000		30,000	61,200
1994	9,240	150,000		30,000	60,600
1993	8,994	235,840		30,000	57,600
1992	8,728	228,860		30,000	55,500
1991	8,475	222,220		30,000	53,400
1990	7,979	209,200		30,000	51,300
1989	7,627	200,000		30,000	48,000
1988	7,313	–		30,000	45,000
1987	7,000	–		30,000	43,800