DC-2 STUDY GUIDE

401(k) PLANS AND INTERMEDIATE ADMINISTRATION TOPICS

10TH EDITION

AMERICAN RETIREMENT ASSOCIATION

Working for America's Retirement

DEFINED CONTRIBUTION PLAN SERIES, VOLUME 2

The ASPPA Defined
Contribution Plan Series, Volume 2

401(K) PLANS AND INTERMEDIATE ADMINISTRATION TOPICS

10th Edition

Excerpts taken from *The ERISA Outline Book*
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AMERICAN
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Working for America's Retirement

The ASPPA Defined Contribution Plan Series consists of three volumes:

Volume 1: Plan Qualification and Compliance Basics

Volume 2: 401(k) Plans and Intermediate Administration Topics

Volume 3: Advanced Compliance and Administration Topics

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10th Edition

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NOTABLE FEATURE

The ASPPA Defined Contribution Plan Series is intended to serve a dual purpose: to provide educational materials **to** candidates preparing for examinations and to serve as a reference material. In response to exam candidates' comments regarding the length of the books and difficulty distinguishing the material needed for examination purposes, we created the following heading to identify topics that are important to the subject being discussed, but will not be tested on the ASPPA DC-2 examination.

If You're Curious …

When you see the above heading, it is an indicator that the material included in the box, while important, will not be included on the examination.

CHAPTER 1:

401(K) BASICS

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1.01: Key Terms

- 401(k) arrangement
- ADP test limit
- After-tax employee contributions
- Allocable earnings
- Allocation formula
- Automatic enrollment
- Cash or deferred arrangement (CODA)
- Catch-up contributions
- Catch-up eligible participant
- Constructive receipt principles
- Contribution formula
- Designated Roth contribution
- Effective opportunity
- Elective contribution
- Elective deferral
- Eligible automatic contribution arrangement (EACA)
- Excess deferral
- IRC §401(a)(30) limit
- IRC §402(g) dollar limit
- IRC §415(c) limit
- Matching contribution
- Negative election or negative enrollment
- Nonelective contribution
- Permissible withdrawal
- Plan-imposed limit
- Pre-ERISA money purchase plan
- Pre-tax catch-up contribution
- Pre-tax elective contribution
- Roth catch-up contribution
- Qualified automatic contribution arrangement (QACA)
- Qualified CODA
- Qualified default investment arrangement (QDIA)
- Qualified matching contribution (QMAC)
- Qualified nonelective contribution (QNEC)
- Salary reduction agreement
- True-up
- Universal availability test

1.02: Introduction

Since the late 1980s, 401(k) plans have become enormously popular in the U.S. These plans promote retirement savings for the employees' benefit and enable a company to approach planning for the employees' future in a manner that fits the company's philosophy and financial ability. If the employer is in no financial position (or is not inclined) to help employees save for retirement, these plans provide employees with a very advantageous method of doing so on their own. If the company believes in a team approach to retirement savings, a 401(k) plan enables the company to encourage employees to save on their own, to reward such savings by matching the employees' contributions in some fashion, and to make additional across-the-board contributions when desired. Finally, if the employer wants to make sufficiently generous contributions to fund the employees' retirements, a 401(k) plan permits employees to add more to that nest egg to make their later years even more comfortable.

With almost anything in the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC), something good always comes with a price, and 401(k) plans are no

exception. In exchange for the wonderful flexibility and shared responsibility of 401(k) plans come more complex requirements to maintain plan qualification and to demonstrate nondiscrimination.

1.03: What Is a 401(k) Arrangement or CODA?

A **cash or deferred arrangement** or CODA is an arrangement that permits an employee to elect between receiving compensation in cash or having compensation deferred to a qualified plan.[1] The CODA must satisfy the requirements of IRC §401(k) for the deferred compensation to be nontaxable at the time of deferral.[2] The terms 401(k) arrangement and qualified CODA also are used to refer to the cash or deferred arrangement in a qualified plan.

WHY HAVE A 401(K) PLAN?

A 401(k) arrangement is the only means by which an employee has individual flexibility over determining the amount of contributions that are to be contributed to a qualified plan on his or her behalf. When the employer makes nonelective contributions—that is, profit-sharing contributions—the contribution level is determined by the employer or by a formula mandated in the plan, and the employee cannot choose to have less or more contributed on his or her behalf. The individual contribution flexibility afforded through the 401(k) arrangement may be especially important to a group of owners who are eligible participants in the plan but have different contribution objectives.

The 401(k) arrangement also provides a means of cost sharing between the employer and the employees for the qualified plan benefits. When the employer makes nonelective contributions, the amount contributed to the plan is not withheld from the employees' paychecks. The employer contribution is in addition to its payroll obligations. Of course, an employer that maintains a qualified plan may take into account the cost of plan contributions in setting pay scales, determining annual pay increases and establishing discretionary bonuses, but there is no direct correlation between the plan contribution and the employees' compensation levels.

In a 401(k) arrangement, an employee's election to defer compensation into the plan has a direct effect on his or her current compensation: the employee is giving up the right to receive a portion of his or her current cash compensation in exchange for a plan contribution to be made for his or her benefit in the form of an elective deferral. Therefore, the employer's total outlay for plan benefits and cash compensation is not affected by an employee's 401(k) deferral election. The employees are bearing part of the cost of providing for retirement benefits by foregoing current

[1] Treas. Reg. §1.401(k)-1(a)(3).
[2] Treas. Reg. §1.402(a)-1(d).

compensation through the 401(k) arrangement. The employer will bear the remainder of the cost to the extent the plan calls for matching contributions and/or nonelective contributions.

METHOD OF ELECTION BETWEEN CURRENT AND DEFERRED COMPENSATION

Cash or Deferred Election

The most popular form of election under a CODA is a salary reduction agreement, in which the employee agrees to reduce compensation in exchange for the deferral of the reduced amount through its contribution to the plan. The salary reduction agreement may apply to current salary, to a salary increase or to a bonus, commission or other form of compensation for services. In lieu of a salary reduction arrangement, a CODA may be designed so that the employee makes an election whether to receive in cash a portion of what the employer would otherwise contribute to the plan. For example, the employer might agree to contribute 5 percent of compensation to a profit-sharing plan for each participant, but each participant is allowed to make an election to receive all or part of that contribution in cash instead. Because the participant has the election to receive cash, any portion of the 5 percent employer contribution that is not taken in cash is treated as made to the plan under a CODA.

The employee's election can be a negative election (also known as negative enrollment or automatic enrollment) under the plan. Under this structure, the employee's compensation is automatically reduced by a percentage specified in the plan (e.g., 3 percent) unless the employee makes a contrary election.[3] Automatic enrollment may be subject to automatic annual increases up to a cap amount specified in the plan document.

A contribution made to a qualified plan under a CODA is called an elective contribution.[4] (Practitioners commonly also refer to elective contributions as "elective deferrals" or "salary deferrals," which is a misnomer because nonsalary compensation, such as bonuses or commissions, may be deferred under the participant's election.) Elective contributions can be made on a pre-tax basis or a post-tax basis.

Pre-tax elective contributions are subtracted out of an employee's compensation for determination of income tax withholding because they are not subject to income tax. Furthermore, pre-tax elective contributions are not shown as taxable compensation on the employee's Form W-2 at year-end.

Designated Roth contributions are elective contributions that are made on an after-tax basis and are subject to special taxation rules on distribution. They will be discussed further below.

Elective contributions, whether made on a pre-tax or post-tax basis, are subject to FICA withholding (i.e., withholding of Social Security and Medicare taxes), and the employee's Social Security benefit will be determined based on the employee's gross (pre-deferral) compensation.[5]

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[3] Treas. Reg. §1.401(k)-1(a)(3)(ii), Rev. Rul. 98-30 and Rev. Rul. 2000-8.
[4] [4] IRC §402(g).
[5] IRC §3121(v).

Pre-tax elective contributions and designated Roth contributions (collectively referred to as "elective deferrals") are subject to both the contribution limits under IRC §402(g), and the rules under IRC §401(k). These will be discussed in more detail in this text.

Cash Availability Requirement

A qualified CODA is defined as an arrangement that provides that the amount each eligible employee may defer is available to such employee in cash, so that the employee's election is between cash compensation and deferred compensation.[6] Thus, the right to receive cash rather than having a plan contribution (or other benefit) is a necessary element of this type of election. This is inherent in the methods of making such an election.

For example, the IRS examined a situation in which the plan allowed an employee who did not use all of his paid vacation to elect to have some or all of this time converted to its equivalent in pay and contributed to the plan for the employee's benefit. The employee's only options with respect to the vacation time were: (1) take the vacation, (2) have the value contributed to the plan or (3) forfeit the unused time. There was no cash election (or other taxable benefit that could be elected) with respect to the unused vacation time. The IRS ruled that, because there was no option for a cash or other taxable benefit, the election to have the value of the vacation time contributed to the plan was not a cash or deferred election subject to IRC §401(k). The contribution was treated by the IRS instead as a nonelective contribution made by the employer.[7] Conversely, the IRS has ruled that a structure allowing an employee to take unused vacation pay in cash or to elect to have it contributed to a 401(k) plan is a cash or deferred election under IRC §401(k).[8]

If You're Curious …

Severance Payments Not a Source of Elective Contributions Under a CODA

An employer might pay an employee severance benefits that extend beyond the date of the employee's termination date. For example, a former employee might receive monthly severance benefits for a six-month period. The question arises whether the former employee should be permitted to make elective contributions to the employer's 401(k) plan from these severance payments. Generally, post-termination severance payments are not eligible compensation for 401(k) deferral purposes.[9]

The IRS issued final regulations under IRC §415 that clarify when post-termination payments may constitute compensation. Under the regulations, post-termination payments may be included in compensation only if: they would have been paid even if termination of employment had not occurred, they are paid by the later of 2½ months after the severance or the end of the limitation year and they are paid for regular service during the employee's regular working hours. For example, payments of accrued sick time and vacation that are actually paid after severance may be included in compensation (assuming the other

[6] Treas. Reg. §1.401(k)-1(e)(2).
[7] TAM 9635002.
[8] Rev. Rul. 2009-31, I.R.B. 2009-39 (Sep. 21, 2009).
[9] Treas. Reg. §1.415-2(e)(3).

requirements of the regulations are met), because these are amounts that would ultimately be paid to the participant even if he or she continued to work for the company. Conversely, severance payments are, by definition, amounts that are payable because of the participant's termination of employment. As such, the regulations provide that they are never includible in compensation for qualified plan purposes.[10]

TYPES OF QUALIFIED PLANS THAT MAY CONTAIN A CODA

A qualified plan may include a CODA only if it is a profit-sharing plan, a stock bonus plan or a pre-ERISA money purchase plan.[11] The existence of a CODA in a pension plan (i.e., defined benefit plan, money purchase plan, target benefit plan) will disqualify that plan, because IRC §401(k) does not permit such plans to include a cash or deferred arrangement.

A **pre-ERISA money purchase plan** is a plan that was in existence on June 27, 1974, and otherwise satisfies the definition of a pre-ERISA money purchase plan contained in IRC §401(k)(6). In general, this requires the plan to limit employer and employee contributions to the levels available in 1974.

EMPLOYERS THAT ARE PROHIBITED FROM SPONSORING A 401(K) PLAN

State or local governmental employers are prohibited from adopting 401(k) plans (unless they are eligible under certain grandfather rules). This prohibition includes a political subdivision of a state or local government, or an agency or instrumentality of such state, local government or political subdivision. The prohibition on governmental employers applies only to 401(k) plans, and not to profit-sharing plans.

Exceptions to Prohibition

The Federal government, including agencies or instrumentalities of the Federal government, may sponsor a 401(k) plan. In addition, Indian tribal governments and rural cooperatives may sponsor 401(k) plans.[12]

Nongovernmental tax-exempt organizations are permitted to establish and maintain 401(k) arrangements, without limitation.

1.04: Types of Contributions in a 401(k) Plan

There are four types of contributions that may be made to a 401(k) plan: elective contributions, after-tax employee contributions, matching contributions and nonelective contributions. There are two types of elective contributions—pre-tax elective contributions and designated Roth contributions. Both types of contributions are discussed further below.

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[10] *Id.*
[11] IRC §401(k)(1).
[12] IRC §§401(k)(4)(B)(iii), 401(k)(7).

The only contributions that you will always see in a 401(k) plan are pre-tax elective contributions. A plan must have pretax elective contributions to be a 401(k) plan—a plan permitting only designated Roth contributions is not permitted. Some 401(k) plans are designed to provide for pre-tax elective contributions only. Other plans provide for some combination of the various contribution types, such as both pre-tax elective contributions and designated Roth contributions, elective contributions and matching contributions, or elective contributions, matching contributions and nonelective contributions.

The plan is still treated as a type of profit-sharing plan or stock bonus plan, as designated by the document, regardless of which types of contributions are provided, even if elective contributions are the only contributions made by the employer. Practitioners and the public commonly refer to qualified plans that offer a CODA as "401(k) plans." Notwithstanding the frequency with which this name is used (and, as you can see, we use it here in this book), it is truly a misnomer because CODA or 401(k) is simply a feature offered as part of a profit-sharing plan or stock bonus plan. It is really not a separate type of plan, in and of itself.

ELECTIVE CONTRIBUTIONS

There are several types of elective contributions. This section will provide a general description of these types of contributions. They will all be discussed in further detail later in the chapter.

Pre-tax Elective Contributions

Pre-tax elective contributions are amounts contributed to a plan by the employer at the employee's election that are excludable from the employee's gross income.[13] Pre-tax elective contributions may be contributed to a 401(k) arrangement, a SIMPLE 401(k) plan, a 403(b) plan, a SARSEP, a SIMPLE IRA plan or a 457 plan. IRC §402(g) limits an individual's pre-tax elective contributions that can be made for a calendar year. As these contributions are pre-tax contributions, they are not treated as basis for tax purposes. These contributions are tested for nondiscrimination in the actual deferral percentage (ADP) test under IRC §401(k).

Designated Roth Contributions

A plan may permit **designated Roth contributions**. This special type of elective contribution is made with after-tax dollars. Furthermore, the rules for taxing designated Roth amounts and the earnings thereon when they are distributed are different from those for pre-tax elective contributions or after-tax employee contributions. In particular, while the amount of the after-tax contributions will always be distributed on a tax-free basis (because the contributions were taxed at the time they were made), the entire distribution from a designated Roth account (including both the after-tax contributions and the earnings thereon) may be completely tax-free if certain conditions are met.

Catch-Up Contributions

IRC §414(v) permits certain participants to make elective contributions to a 401(k) plan in amounts in excess of various otherwise applicable limits. These elective contributions are referred to as **catch-**

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[13] Treas. Reg. §1.402(g)-1(b).

up contributions. A participant who is (or will be) age 50 or older by the end of the calendar year is a **catch-up eligible participant**. Catch-up contributions may be made to a 401(k) plan, a SIMPLE 401(k) plan, a 403(b) plan, a SARSEP, a SIMPLE IRA plan or a 457 plan, if the plan so permits. Catch-up contributions attributable to pre-tax elective contributions are referred to as **pre-tax catch-up contributions** and catch-up contributions attributable to designated Roth contributions are referred to as **Roth catch-up contributions**.

AFTER-TAX EMPLOYEE CONTRIBUTIONS

Although this feature is much less popular since the mid-1980s, qualified plans may permit participants to elect to make **after-tax employee contributions** (that are not designated Roth contributions) to the plan. These contributions are considered to be annual additions under IRC §415, so they are subject to the limitation under IRC §415(c)—that is, the lesser of 100 percent of compensation or $57,000 (for 2020, subject to cost-of-living adjustments in the future). After-tax employee contributions are also subject to nondiscrimination testing in the same manner as are matching contributions—that is, under the actual contribution percentage (ACP) test. Therefore, use by an HCE of the after-tax employee contribution feature in a plan may be limited.

Because these contributions are made with after-tax dollars—that is, they are subject to income tax in the year contributed—no tax needs to be paid by the participant when the contributions are removed from the plan. However, earnings on the after-tax employee contributions are subject to taxation upon distribution.

MATCHING CONTRIBUTIONS

Matching contributions are employer contributions that are made on account of elective contributions or after-tax employee contributions. The term also includes forfeitures that are allocated as matching contributions.[14] These types of contributions are tested for nondiscrimination purposes in the actual contribution percentage (ACP) test under IRC §401(m).

NONELECTIVE CONTRIBUTIONS

Nonelective contributions are employer contributions to a qualified plan that are not elective contributions made under a 401(k) arrangement and are not matching contributions.[15] This term is usually used in the context of a 401(k) plan, to distinguish profit-sharing contributions from the contributions the employer makes pursuant to the employees' salary reduction agreements (elective contributions) and from the matching contributions made in relation to those elective contributions. However, the term could be used in general to refer to all employer contributions (other than matching contributions) to any type of plan. These types of contributions are tested for nondiscrimination purposes under IRC §401(a)(4).

Qualified Nonelective Contributions (QNECs)

If a plan fails to pass the nondiscrimination testing in relation to elective deferrals, matching contributions, or after-tax employee contributions, there are several manners in which the employer

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[14] Treas. Reg. §1.401(m)-1(f)(12).
[15] Treas. Reg. §1.401(m)-1(a)(2).

may correct the failure. One method is to contribute a **qualified nonelective contribution** (QNEC). A QNEC is a contribution made by the employer that is 100 percent vested when made and subject to the same distribution limitations as elective deferrals. It is often used in the ADP or ACP nondiscrimination testing to help the plan pass the test.

If QNECs are allocated only to the accounts of NHCEs, there is significant flexibility as to how such allocations may be made. [An additional contribution to NHCEs only is, by definition, nondiscriminatory under both the amounts and the benefits, rights and features portions of IRC §401(a)(4).] This flexibility may be limited by the plan document.

Qualified Matching Contributions (QMACs)

If the QNEC is allocated in proportion to elective deferrals, it constitutes a matching contribution. Therefore, such QNECs are called **qualified matching contributions** (QMACs). The only difference between a QNEC and a QMAC is the manner of allocation.

1.05: Elective Deferral Contributions

A 401(k) plan must provide for a procedure by which the amount of the elective contributions for each participant is determined. The employer is required to transmit these amounts to the plan as part of its contribution.

EMPLOYEE MUST BE AN ELIGIBLE PARTICIPANT

Before elective contributions can be made on an employee's behalf, the employee must first qualify as a plan participant. An employee who is eligible to make an elective contribution, but chooses not to do so, may be a participant for other purposes. For example, the employee may be entitled to an allocation of nonelective contributions or top-heavy minimum contributions.

SALARY REDUCTION AGREEMENT

An employee's election to defer compensation is usually implemented through a salary reduction agreement.

EXAMPLE 1-1. Salary Reduction Agreement. Michael is a participant in a profit-sharing plan with a 401(k) arrangement. Michael's salary is $480 per week ($24,960 per year, if there are 52 weekly payroll periods). He enters into a salary reduction agreement to defer 3 percent of compensation to the 401(k) arrangement.

Pursuant to this agreement, the employer withholds 3 percent of Michael's weekly compensation (i.e., 3% x $480, or $14.40 per week). Assuming 52 pay periods in the year, this works out to a total contribution for the year of $748.80. The amounts withheld are contributed by the employer to the plan as part of its contribution.

In other words, Michael is instructing the employer to pay him less cash compensation than he would otherwise be paid for each pay period, and defer that compensation to the plan as part of the employer's contribution made on Michael's behalf.

Employees may be permitted to make or modify their deferral elections through electronic media, such as a voice-response system or a plan website.[16]

Many 401(k) plans permit plan participants to direct the investment of all or a portion of their accounts. The salary reduction election is an ideal format for making investment selections available. In many cases, the form, once completed by the participant, will not only specify the amount of compensation the participant wishes to defer under the 401(k) arrangement, but also the participant's investment selections.

Currently Available Compensation

The employee cannot make an election to defer compensation that is already currently available at the time of the election.[17] The compensation is currently available as of a date if the compensation has already been paid by such date, or the employee is able currently to receive the cash at the employee's discretion.

This rule is based on the **constructive receipt principles** that normally apply to the taxation of income. Usually, if a taxpayer is in control of whether to immediately receive taxable compensation or have it deferred, the IRC considers the person to have constructively received the money and it is immediately taxable—even if the individual then elects to defer actual receipt.

IRC §401(k) is a statutory exception to the constructive receipt rule, permitting employees to control whether to receive future compensation through the salary reduction election. Under IRC §401(k), employees may exclude from gross income the amount of the pre-tax elective contributions, subject to the dollar limit provided in IRC §402(g) ($19,500 in 2020). However, once the employee has received the funds or can actually receive the funds upon demand (i.e., they are currently available), the IRC §401(k) exception evaporates and the taxation rules of constructive receipt apply to tax the funds immediately.

Note that the participant may defer compensation that was already earned but is not yet payable. As a result, a salary reduction agreement may be effective as to compensation already earned (i.e., the employee has already performed the services) but for which the payroll date has not yet occurred.[18]

EXAMPLE 1-2. Deferral of Compensation Earned, But Not Yet Payable. Suppose that, in EXAMPLE 1-1, Michael gets paid every Friday. On Thursday afternoon, Michael decides he would like to participate in the employer's 401(k) plan. Michael goes to the HR office and completes a salary reduction election. Even though Michael already worked from Monday through Thursday, his

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[16] Treas. Reg. §1.401(a)-21 and IRS Notice 99-1.
[17] Treas. Reg. §1.401(k)-1(a)(3)(iii).
[18] [18] IRM 7(10)54, §442.41(1)(b)(1); IRS Announcement 94-101, IRB 1994-35 (8/12/94).

election may be effective for the entire week, because he is not due to be paid for that work until Friday. As a result, the compensation to be deferred is not currently available.

Employees cannot elect to defer compensation that becomes available before the 401(k) arrangement is established.[19] The 401(k) arrangement is established as of the later of:

- the date the arrangement is adopted, or
- the date the arrangement is effective.

EXAMPLE 1-3. 401(k) Established. An employer adopts a 401(k) plan on June 30, by executing a pre-approved plan adoption agreement on such date. The plan is effective retroactive to the preceding January 1. The later of the adoption date or the effective date is the July 30 adoption date. Therefore, salary reduction agreements may apply only to compensation that becomes currently available after June 30.

Automatic (or Negative) Enrollment

Some 401(k) plans use an **automatic enrollment** approach to obtain salary reduction elections from eligible employees. Under automatic enrollment, the plan provides that, as of the plan entry date when the employee is first eligible for the 401(k) plan, the employee is automatically enrolled at a default elective contribution rate. Of course, the employee is free to change the automatic enrollment by signing a form that specifies a different election, including zero (thereby electing against participation). Because the employee has to make a contrary election to avoid the automatic enrollment, this approach is sometimes referred to as **negative enrollment** or **negative election**. Automatic enrollment programs are referred to in Treasury regulations as **automatic contribution arrangements** (ACAs).

EXAMPLE 1-4. Automatic Enrollment. An employer amends its 401(k) plan to provide that, as of the next January 1, the plan will include a 3 percent automatic enrollment feature. The feature will apply to employees who first become eligible for the plan on or after that January 1, and to already eligible employees who, as of such date, either are not deferring or are deferring at a rate less than 3 percent.

For the already eligible employees who are subject to the amendment, the employer will provide notice of the feature within a reasonable period of time prior to the January 1 effective date of the automatic enrollment feature. If, before January 1, the employee fails to make a contrary election— either to have no elective contributions withheld or to defer at a rate that is greater or less than 3 percent— the employer will begin withholding at a 3 percent rate starting with the first paycheck issued on or after the effective date. At any time, the employee may file a contrary election, which will be given effect as of the first pay period ending after the

[19] Treas. Reg. §1.401(k)-1(a)(3)(iii).

election is filed. Contributions made under the automatic enrollment feature are treated as elective contributions.

ERISA Preemption

Some states prohibit payroll withholding if the employee has not agreed in writing to such withholding. ERISA preempts state law to the extent it would interfere with an eligible automatic contribution arrangement, as defined by the IRC.[20]

Eligible Automatic Contribution Arrangement

An eligible **automatic contribution arrangement** (EACA) is an elective contribution arrangement under which:

- A participant has an option to elect to defer cash compensation by having the employer make a contribution to the plan instead;
- A participant is treated as having made a deferral election in the amount of a uniform percentage (no minimum or maximum percentage was set by the statute) of compensation until the participant specifically elects not to have such contributions made (or to have a different percentage contributed) (i.e., the plan has an automatic enrollment feature); and
- The notice requirements of IRC §414(w)(4) are satisfied.[21]

The required notice must be given within a reasonable period of time before each plan year to each employee to whom the EACA applies for such plan year. This has been interpreted by regulation to be not later than 30 days or earlier than 90 days before the beginning of the plan year (or the date of hire, if later).[22] The notice must include the following information:

- An explanation of the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contribution made at a different percentage), and
- An explanation of how contributions made under the arrangement will be invested in the absence of any investment election by the employee.

The notice must be written in a manner that is sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations under the plan, and in a manner calculated to be understood by the average employee to whom the arrangement applies.

Extension of ADP/ACP Correction Period Without Excise Tax Applicability

An EACA has 6 months, rather than 2½ months, after the close of the plan year to make corrective distributions to HCEs to correct a failure of the ADP and/or ACP tests, without incurring the 10 percent excise tax under IRC §4979.

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[20] ERISA §514, as amended by PPA §902(f).
[21] IRC §414(w)(3), as added by PPA §902.
[22] Treas. Reg. §§1.401(k)-3(d)(3); 1.414(w)-1(b)(3).

Qualified Automatic Contribution Arrangement

A **qualified automatic contribution arrangement** (QACA) is an EACA that satisfies additional requirements. A QACA is a form of 401(k) safe harbor plan; meeting the QACA requirements exempts the plan from the ADP and ACP nondiscrimination testing.

An additional advantage of being a QACA is that the plan will qualify for an exemption from the top-heavy rules if no nonelective contributions are made.

Comparison Chart

The following chart identifies the similarities and differences between three levels of an ACA.

Feature	Automatic Contribution Arrangement (ACA)	Eligible Automatic Contribution Arrangement (EACA)	Qualified Automatic Contribution Arrangement (QACA)
Participant Notice Timing Requirement	Required	Required	Required
Safe Harbor Compensation	Not required	Not required	Required
Automatic Salary Deferral Percentage	Required – defined in the plan document	Required – defined in the plan document	Required – defined in the plan document
Specified Automatic Salary Deferral Contribution Levels	None	None	Minimum of 3%; Gradually tiered to at least 6%, not to exceed 10%
Automatic Annual Deferral Escalation that Satisfies Uniform Percentage Rule / Qualified Percentage	Optional	Optional	Minimum Deferral Rates: Up to 2 yrs – 3% 3 yrs – 4% 4 yrs – 5% 5 yrs – 6% May begin deferral at 6% to avoid escalation, or may continue escalation beyond 5th year; however, deferral escalation may not ultimately exceed 10% of compensation
Required Employer Matching OR Nonelective Contribution for Each Eligible NHCE regardless of Salary Deferral Election	Not required	Not required	Required: Match – 100% of 1st 1% + 50% of deferral over 1% up to 6% OR Nonelective – 3% of Compensation

Feature	Automatic Contribution Arrangement (ACA)	Eligible Automatic Contribution Arrangement (EACA)	Qualified Automatic Contribution Arrangement (QACA)
Required Vesting Schedule for Employer Contributions	Standard permissible schedules for qualified DC plans	Standard permissible schedules for qualified DC plans	Fully vested after no more than 2 yrs
Permissible 90-Day Withdrawal Option	Not permitted	Required – However without the 10% tax penalty for early withdrawals	Optional – but an EACA provision must be incorporated to allow
Qualified Default Investment Alternative – Fiduciary Protection	Optional – QDIA highly recommended	Optional – QDIA highly recommended	Optional – QDIA highly recommended
Safe Harbor Available to Avoid Nondiscrimination Tests & Top Heavy Rules	No	No – However excise tax doesn't apply for corrective distributions within 6 months after plan year end	Yes

Elections by Self-Employed Individuals

A sole proprietor or a partner of a partnership can be a participant under the employer's 401(k) plan. The employer of these individuals is the sole proprietorship (i.e., the individual himself) or partnership, depending on the context.[23] For salary reduction purposes, the self-employed individual's compensation [i.e., his or her earned income under IRC §401(c)(2)] is not treated as currently available until the end of the sole proprietorship's or partnership's tax year. Thus, the salary reduction election to defer earned income for such year may be made up to the end of that year.[24]

The IRS has ruled that elective contributions may be made from advances (draws) to partners of their distributive share of partnership earnings, because the advances are being made before the earned income is made available.[25] As a cautionary note, however, advances being treated as representative of a partner's distributive share of earnings should be determined on a conservative basis, particularly where elective contributions are being withheld, because the ultimate earned income under IRC §401(c) will not be determinable until the end of the partnership taxable year. It is possible that the final earned income will not be sufficient to support the level of elective

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[23] IRC §401(c)(4).
[24] Treas. Reg. §1.401(k)-1(a)(6).
[25] PLR 200247052.

contributions withheld from the partner's advances during the year, or might result in a much higher deferral percentage for nondiscrimination purposes than was anticipated.

COMPENSATION ELIGIBLE FOR DEFERRAL

When we hear the term "salary reduction agreement," we usually think in terms of an amount being withheld from a regularly scheduled paycheck. However, the employee might not receive a regular paycheck, or the employee might receive separate bonuses or other special compensation payments from time to time. The salary reduction agreement may apply to these irregular compensation payments as well, so long as the election to defer from such payments is made before the payments are currently available to the employee.

The plan document must define what compensation is includible for purposes of the salary reduction elections. Normally, a 401(k) plan will permit eligible employees to make salary reduction elections against all forms of compensation, including base salary, overtime wages, commissions, bonuses and other forms of taxable compensation. But the plan document may restrict the elections to only certain forms of compensation (e.g., base salary only). In determining how to define compensation for this purpose, the employer should consider:

1. its reasons for desiring any limitations on the compensation available for deferral;
2. administrative complexity created by any limitations and the increased chance for error; and
3. the reasonableness of any limitation.

EXAMPLE 1-5. Compensation for Elective Deferral Purposes. A 401(k) plan provides that an eligible employee may make salary reduction elections only against base salary (i.e., exclusive of overtime, bonuses, commissions). Julius' base salary is $30,000 per year. He usually earns some overtime each year and, in some years, receives a bonus. For the current plan year, Julius elects a deferral rate of 6 percent under the 401(k) plan.

His total compensation for the year is $38,000 (i.e., his base salary of $30,000 plus other compensation of $8,000). Julius' elective contribution for the year is $1,800 because, under the terms of the plan, the 6 percent election is applied only to base salary (i.e., 6% x $30,000).

If Julius would like to defer an amount that equals 6 percent of his total compensation (i.e., 6% x $38,000, or $2,280), he needs to increase the deferral rate against his base salary. A total elective contribution of $2,280 from $30,000 of base salary would require a 7.6 percent deferral rate.

IRC §414(s) and the regulations thereunder outline how compensation must be defined to constitute a nondiscriminatory definition of compensation. However, there is no requirement that the definition of compensation that is eligible for deferral under a 401(k) arrangement be

nondiscriminatory.[26] This is true even for safe harbor 401(k) plans,[27] although regulations do require that QACAs provide for nondiscriminatory deferrable compensation.[28] If the definition of compensation for elective contributions does not satisfy IRC §414(s), then a different definition of compensation will have to be used to perform the ADP nondiscrimination test.[29]

Although the definition of eligible compensation for deferral purposes need not satisfy IRC §414(s), it must be a reasonable definition. A definition that excludes bonuses, overtime, premiums for shift differential or call-in premiums is automatically considered to be a reasonable definition.[30] The definition may not simply disregard a percentage of an employee's compensation. The base salary definition in **EXAMPLE 1-5** above would satisfy the reasonable definition requirement.

If the plan defines eligible compensation for deferral purposes differently for separate groups of employees, there is another nondiscrimination testing issue to consider. Suppose, for example, that the plan provides that salaried employees may defer from all compensation, but hourly paid employees may not defer out of bonuses. Each possible rate of deferral under a 401(k) plan must be available on a nondiscriminatory basis.[31] A rate of deferral is based on the plan's definition of compensation out of which the elective contributions are made. If there are multiple definitions of compensation that are not substantially the same, the plan will be treated as if different deferral rates exist, and the plan may be required to demonstrate that these various deferral rates do not violate the benefits, rights and features provisions of IRC §401(a)(4).

If You're Curious …

Effect of Cafeteria Plan on Compensation for Deferral Purposes

In some cases, an employer maintains both a 401(k) plan and a cafeteria plan (also known as an IRC §125 plan or a flexible spending account (FSA)). Under the 401(k) plan, the employee may elect to defer a percentage of compensation, and under the cafeteria plan, the employee may elect to reduce his or her compensation to purchase certain nontaxable benefits (such as health insurance premiums or medical expense or day care expense reimbursement). Should the 401(k) deferral be determined before or after the cafeteria plan reduction? This is primarily an administrative issue because the 401(k) plan document will rarely be that specific (although ideally, the document should address it). More importantly, the administrator should communicate the procedure to the employees so the employees will take it into consideration when making elections.

EXAMPLE 1-6. Coordination of Deferrals and Compensation for a Company That Maintains Both a 401(k) Plan and a Cafeteria Plan. Company X maintains a 401(k) plan and a cafeteria plan. Brittany earns $2,000 per pay period. Her cafeteria plan

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[26] Treas. Reg. §1.401(a)(4)-4(e)(3).
[27] Treas. Reg. §1.401(k)-3(b)(6)(iv) and IRS Notice 98-52, Section V.B.1.c.iii.
[28] Treas. Reg. §1.401(k)-3(j)(1)(i).
[29] Treas. Reg. §1.401(k)-6.
[30] Treas. Reg. §1.414(s)-1(d)(2).
[31] Treas. Reg. §1.401(a)(4)-4(e)(3)(iii)(D).

contribution is $200 per pay period. Brittany elects to defer 5 percent of compensation into the 401(k) plan. If the plan determines the 401(k) contribution before the cafeteria plan reduction, then Brittany's 401(k) contribution per pay period is 5% x $2,000, or $100. If the plan determines the 401(k) contribution after the cafeteria plan reduction, then Brittany's 401(k) contribution per pay period is 5% x $1,800, or $90.

Both approaches are permissible. The procedure used by the plan should be communicated so that Brittany adjusts her election accordingly. For example, if the plan calculates the 401(k) contribution after the cafeteria plan reduction, but Brittany wants a deferral of $100 per pay period, then she should defer at a rate of 5.56 percent (i.e., $1,800 x 5.56% = $100) or she should elect a specific dollar amount deferral (if the plan permits) of $100 per pay period.

ELECTIVE CONTRIBUTIONS TREATED AS EMPLOYER CONTRIBUTIONS

Although the elective contributions under a 401(k) arrangement are made at the participant's election, the elective contributions are treated as employer contributions for IRC purposes.[32] This rule is important when determining taxation of distributions. On the other hand, the DOL does not treat these amounts as employer contributions for purposes of Title I of ERISA. Instead, the elective contributions are treated as participant contributions and are subject to special rules relating to the timing of the transmission of these amounts by the plan sponsor to the trust.

ADMINISTRATIVE ISSUES FOR ELECTIVE CONTRIBUTIONS

When an elective contribution is deducted from the employee's paycheck, the employer is required to transmit that contribution as soon as possible to the trust. The DOL has established rules outlining the appropriate time frames during which the contributions must be actually deposited to the trust, after which the employer is treated as being in improper possession of plan assets.[33] The purpose of this rule is to ensure that the elective contributions are transferred to the trust promptly so that the contributions are protected from the claims of the employer's creditors and can begin to earn investment returns.

DOL regulations permit the contributions to be transmitted to the plan as soon as administratively feasible, but not later than the 15th business day following the end of the month during which the contributions would have otherwise been paid as compensation. However, the latter clause is all but ignored in practice. DOL officials have been clear in pronouncements that employers are expected to transmit the funds as soon as they can. A "safe harbor" rule has made this more definitive for plans with fewer than 100 participants. Under that rule, the transmittal is deemed to be reasonable if it occurs within seven business days of the payroll date on which the elective contribution occurred.[34]

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[32] IRC §402(e)(3).
[33] DOL Reg. §2510.3-102.
[34] DOL Reg. §2510.3-102(a)(2).

The plan will include a provision that allocates an employee's elective contributions under the 401(k) arrangement to the employee's account in the plan.

EXAMPLE 1-7. Elective Contribution Allocation. Consider two participants in a 401(k) arrangement, each paid on a semi-monthly basis. Pursuant to the 401(k) arrangement, Suni elects to reduce her salary by $50 per pay period and to have that amount contributed on her behalf to the plan.

Forrest elects to reduce his salary by $75 per pay period and to have that amount contributed on his behalf to the plan.

The employer contributes $125 to the plan with respect to Suni and Forrest's elective contributions for the last pay period. The administrator must allocate $50 to Suni's account and $75 to Forrest's account to reflect their 401(k) elections.

LIMITS ON ELECTIVE CONTRIBUTIONS

There are four limits that might affect the amount of an employee's elective contributions for a year:

4. the IRC §401(a)(30) limit;
5. the IRC §415 limit;
6. a plan-imposed limit; and
7. the ADP test limit.

IRC §401(a)(30) Limit

IRC §401(a)(30) limits the amount of elective contributions an employee may make to a 401(k) plan in any calendar year. This limit is the dollar amount under IRC §402(g) [and so is known as both the **IRC §401(a)(30) limit** and the **IRC §402(g) dollar limit**]. If the limit is exceeded, a plan may be disqualified for allowing an employee to exceed the limit unless timely corrective action is taken.

The IRC §402(g) dollar limit for 2020 is $19,500. This amount increases periodically for cost of living, in $500 increments.[35] A plan is not treated as violating IRC §401(a)(30) to the extent elective contributions in excess of the IRC §402(g) dollar limit are catch-up contributions under IRC §414(v).

Interaction of IRC §402(g) and IRC §401(a)(30)

IRC §402(g) sets a limit on the amount of elective contributions that may be excluded from gross income by an individual in a single calendar year. The IRC §402(g) dollar limit affects the individual's federal income tax consequences. Thus, it is applied at the participant level and the

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[35] IRC §402(g)(1)(A).

participant must aggregate all elective contributions for the calendar year that are subject to the limit, even if they are made to plans of more than one employer.

IRC §401(a)(30), on the other hand, is a plan qualification requirement under which a 401(k) plan must limit elective deferrals by its individual participants in a calendar year to the applicable IRC §402(g) dollar limit. A 401(k) plan fails to be a qualified plan if it accepts elective contributions on behalf of a participant that exceed the IRC §402(g) dollar limit.

It is possible for a participant to violate IRC §402(g) without having any plan violate IRC §401(a)(30).

EXAMPLE 1-8. Dollar Limits. Suppose that Janice, age 33, is employed by Corporation S from January 1, 2020 through June 30, 2020. During that period of time, her elective contributions to the Corporation S 401(k) Plan total $10,000. Janice terminates employment with Corporation S on June 30, 2020 and begins working for Corporation Y (an unrelated organization) on July 1, 2020.

During the latter half of 2020, elective contributions made on Janice's behalf to the Corporation Y 401(k) Plan total $10,000. For 2020, Janice has exceeded the IRC §402(g) dollar limit of $19,500 by $500 ($10,000 + $10,000 - $19,500).

However, because Janice contributed less than $19,500 to each of the Corporation S and Corporation Y plans, there is no IRC §401(a)(30) violation by either of those two plans. If left uncorrected, Janice will suffer tax consequences for having too much in elective contributions removed from her compensation. Neither of the two plans will suffer negative ramifications.

On the other hand, if either plan had permitted Janice to have more than $195000 contributed on her behalf to that plan, the plan would have violated IRC §401(a)(30) and could be disqualified if the problem is not corrected.

Types of Contribution Subject to the Limit

Only elective contributions are subject to the IRC §402(g) dollar limit. Other employer contributions, such as nonelective contributions, after-tax contributions and matching contributions, are not subject to the limit. If an individual participates in more than one arrangement that permits elective contributions in a calendar year, the IRC §402(g) dollar limit applies to the aggregate amount of the individual's elective contributions under those plans. The IRC §402(g) dollar limit applies to the following amounts:[36]

- Elective contributions under a 401(k) arrangement [including elective contributions under a SIMPLE 401(k) plan or under a safe harbor 401(k) plan]. The limit applies to all elective contributions, regardless of whether they are pre-tax elective contributions or designated Roth contributions.

[36] IRC §402(g)(3) and Treas. Reg. §1.402(g)-1(b).

- Elective contributions made pursuant to a salary reduction agreement under a 403(b) plan.
- Elective contributions under a SARSEP [as described in IRC §401(k)(6)]. SARSEPs may be funded only if they were established before January 1, 1997.
- Elective contributions under a SIMPLE IRA plan [as described in IRC §408(p)]. [Note that SIMPLE IRA plans and SIMPLE 401(k) plans are subject to a reduced elective deferral limit under IRC §408(p).]

There are other types of retirement savings programs or employee benefit programs for which an employee might make salary reduction contributions. These types of contributions are not subject to the IRC §402(g) dollar limit because they are not listed in IRC §402(g). These contributions are also not subject to IRC §401(a)(30). These contributions include:

- ***Salary reductions under 457(b) plans.*** Government 457(b) plans, which may be sponsored by governmental entities and tax-exempt organizations, are deferred compensation arrangements that often allow an employee to make contributions through salary reduction. IRC §457(b) limits elective contributions to a 457(b) plan to the same amount as IRC §402(g), and these limits apply to all compensation contributed on the employee's behalf to a 457(b) plan for a year, regardless of whether the compensation is deferred through salary reduction or otherwise.

  An employee's 457 limit is not affected by the amount of the employee's salary reductions that are subject to IRC §402(g). For example, if an employee makes elective contributions to a 403(b) plan, even if those contributions equal the maximum amount permitted under the IRC §402(g) dollar limit, the employee is still permitted to have maximum elective contributions (as outlined by IRC §457(b)) to a 457(b) plan for that same calendar year.

- ***Salary reductions that are catch-up contributions.*** Catch-up contributions are special elective contributions that may be made on behalf of participants who are age 50 or older during a calendar year and whose elective contributions have equaled one or more limits. One of these applicable limits is the §402(g) limit. Catch-up contributions are excluded from a participant's income, just as elective deferral amounts under the IRC §402(g) dollar limit are.[37] The maximum catch-up contribution permitted in a calendar year (i.e., the catch-up limit) is $6,500 in 2020, increasing periodically for cost of living in $500 increments.[38] Therefore, assuming no other limit has been exceeded, a catch-up eligible participant may defer a total of $26,000 in 2020 [$19,500 under IRC §402(g), plus the catch-up contribution (i.e., the elective contribution in excess of the §402(g) limit) of $6,500].
  Whether the participant is employed by the employer who maintains the plan as of his or her 50th birthday is not relevant, so long as the 50th birthday will be reached no later than the last day of the applicable calendar year. Furthermore, a participant does not fail to be a catch-up eligible participant for the calendar year in which he or she will turn age 50 merely because the participant dies before his or her 50th birthday. Thus, catch-up

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[37] IRC §402(g)(1)(C) and Treas. Reg. §1.402(g)-2(a).
[38] IRC §414(v)(2)(B)(i).

contributions made with respect to such calendar year prior to the individual's death retain their character as catch-up contributions.

EXAMPLE 1-9. Catch-up Eligible. Brian's 50th birthday is on November 10, 2020. Brian is a participant in his employer's 401(k) plan, which has a calendar plan year. The plan permits catch-up contributions. Even though Brian is younger than age 50 for most of the year, he is a catch-up eligible participant for all of 2020 because he will be age 50 before year end. Thus, Brian may elect to have elective contributions of up to $26,000 for 2020 contributed to the plan (i.e., $19,500 regular elective contributions and $6,500 catch-up contributions) unless the plan otherwise limits his elective contributions by its terms or he earns insufficient compensation to support that level of deferral.

More details about catch-up contributions are provided later in this chapter.

- ***Cafeteria plan contributions.*** Pursuant to IRC §125, an employee may offer employees a cafeteria plan under which an employee can purchase certain welfare-type benefits (e.g., health or life insurance benefits, day care reimbursement) through salary reduction. Salary reduction contributions made to a cafeteria plan are not subject to the IRC §402(g) dollar limit, nor are such amounts taken into account to determine whether any contributions described above exceed the IRC §402(g) dollar limit or whether a plan that is subject to IRC §401(a)(30) has exceeded the IRC §402(g) dollar limit with respect to any participant.
  This rule does not apply to elective contributions to a 401(k) plan that are made through a cafeteria plan. IRC §125(d)(2)(B) permits a cafeteria plan to allow a participant to designate that all or part of a salary reduction contribution under the cafeteria plan will be contributed to a 401(k) plan. To the extent of such designation, the salary reduction amount would be contributed as an elective contribution to the 401(k) plan, in which case the limits under IRC §§401(a)(30) and 402(g) do apply to such contribution.
- ***Qualified transportation fringe benefits provided through salary reduction.*** Pursuant to IRC §132(f) (4), an employer may offer qualified transportation fringe benefits (e.g., parking, public transportation costs) and allow employees to purchase these benefits through salary reduction. The amount of salary reduction used to acquire qualified transportation fringe benefits is not subject to the IRC §402(g) dollar limit, nor are such amounts taken into account to determine whether any contributions described above exceed the IRC §402(g) dollar limit, nor whether a plan that is subject to IRC §401(a)(30) has exceeded the IRC §401(a)(30) limit with respect to any participant.
- ***Nonqualified plans.*** Salary reduction contributions made under a nonqualified deferred compensation arrangement, as described in IRC §451, are not limited by IRC §402(g) nor by IRC §401(a)(30).

Summary of Contribution Sources Subject to the IRC §402(g) Limit

The following table summarizes which contribution sources are counted when determining whether a participant has exceeded the IRC §402(g) dollar limit.

Source of Elective Contribution	Counted for IRC §402(g) dollar limit?
401(k) plan	Yes
SIMPLE 401(k) plan	Yes
403(b) plan	Yes
SARSEP	Yes
SIMPLE IRA plan	Yes
Governmental 457(b) plan	No
Cafeteria plan	No
Nonqualified plan	No

Correction of Violations of IRC §402(g)

If an individual's elective contributions exceed the IRC §402(g) dollar limit, the result is an **excess deferral.** This is corrected by distributing from the plan the excess deferral (including net earnings), except to the extent the catch-up rules allow additional elective contributions to be retained in the plan.

A plan is responsible for determining whether a participant has excess deferrals only to the extent the amount of the elective contributions to that plan exceed the plan's IRC §401(a)(30) limit. In other words, elective contributions under a plan that is maintained by an unrelated employer are not taken into account to determine whether a plan has violated the IRC §401(a)(30) limit. If a participant's IRC §402(g) dollar limit is exceeded because of the aggregation of elective contributions under the plans of unrelated employers, but no single plan violates the IRC §401(a)(30) limit, the responsibility falls on the participant to request timely distributions of excess deferrals from the plans involved.

The excess deferrals must be distributed by April 15 to avoid qualification problems (if IRC §401(a)(30) is violated) or taxation ramifications to the participant (due to the violation of IRC §402(g) dollar limit).[39] If the participant is responsible for telling the plan that a distribution is needed, notification must be made by March 1, unless the plan requires an earlier date.

IRC §415 Limit

Elective deferrals (including both pre-tax elective contributions and designated Roth contributions) are part of the annual additions that are limited by IRC §415. The IRC §415(c) limit on annual additions is generally the lesser of 100 percent of compensation or the dollar limit in

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[39] IRC §402(g)(2)(A)(ii), Treas. Reg. §1.402(g)-1(e)(2).

effect under IRC §415(c)(1)(A) for the year. The dollar limit in effect for 2019 limitation years is $57,000. The IRC §415 limit does not apply to catch-up contributions under IRC §414(v).

IRC §415 is not a limit that applies only to elective deferrals, as is the case with the IRC §401(a)(30) limit described above. It applies to all annual additions, which include all employer contributions, after-tax employee contributions and forfeitures allocated to the participant's account for the relevant year.

Qualified plans under IRC §401(a)—including 401(k) plans, SARSEPs, and 403(b) plans— are subject to the limits under IRC §415. It is possible that an employee’s elective deferrals, when added to other annual additions (i.e., employer and after-tax employee contributions and forfeitures) allocated to a participant’s account in the same limitation year, might cause the IRC §415 limit to be exceeded. In that case, the employee may not be able to defer a sufficient amount to reach the IRC §402(g) dollar limit. The IRC §415 limit is tested based on the limitation year, which is a 12-month period stated in the plan; on the other hand, the IRC §402(g) dollar limit is always applied on a calendar year basis.

EXAMPLE 1-10. IRC §415(c) Limit Exceeded. Gary is an eligible participant in a 401(k) plan in which the plan year and limitation year is the calendar year. For 2020, Gary earns only $6,000 of compensation. Because of other household income, Gary is able to defer 90 percent of his compensation, so his elective contributions for 2020 total $5,400. (The plan does not impose a percentage deferral limit.)

The plan provides for a match on the first 5 percent of compensation deferred. For Gary, this is a match of $300. In addition, the employer elects to make a 10 percent profit-sharing contribution this year. For Gary, this is a profit-sharing contribution of $600.

The allocation of match ($300), the profit-sharing contribution ($600), plus the amount of elective contributions ($5,400) totals $6,300. IRC §415(c) limits a participant’s annual additions to 100 percent of compensation. Thus, Gary’s total allocation of $6,300 exceeds his 100 percent limit under IRC §415(c) by $300.

Plan-Imposed Limit

Some 401(k) plans limit the percentage that an employee may contribute, a plan-imposed limit, even though contributing at a higher percentage would not violate the IRC §401(a)(30) limit or the IRC §415 limit. For example, a plan might state that an employee's elective deferrals for the plan year cannot exceed 10 percent of compensation.

Some plans are written with such limits to minimize the chance that the IRC §415 limit will be exceeded when all annual additions (including contributions other than elective deferrals) are taken into account. Other plans provide a plan-imposed limit on the elective deferrals of the HCEs only, in the hopes that this limit will avoid a violation of the ADP nondiscrimination tests. The drafter

of the plan should take care to make sure that any plan-imposed limit is clearly stated for administration purposes.

Generally, plan-imposed limits apply to all elective deferrals, whether they are pre-tax elective contributions or designated Roth contributions. However, it is possible that a plan could impose different limits on the two types of elective deferrals. It is important to carefully review the plan's terms.

EXAMPLE 1-11. Plan Imposes 15 Percent Cap on Elective Deferrals. Frank's annual compensation is $40,000. The plan does not permit a participant to elect to defer more than 15 percent of compensation. The plan-imposed limit would cap Frank's elective deferrals to $6,000 per plan year, precluding the participant from reaching the IRC §402(g) dollar limit.

Plan-imposed limits are usually applied on a plan year basis, which might not be the calendar year. In that case, the plan will need to monitor its plan-imposed limit on the plan year period, but the IRC §402(g) dollar limit on a calendar year period.

Exceeding the plan-imposed limit is an operational violation that may cause the plan to be disqualified. Therefore, if a participant exceeds a plan-imposed limit, the error should be corrected. The IRS has outlined correction procedures that are available in this situation.[40]

Reasonable Restrictions Allowed

Reasonable restrictions on the amount of elective deferrals an eligible employee may make are permissible even if the plan is a safe harbor 401(k) plan. However, any limit on the amount of elective deferrals that can be made, to the extent it is less than the statutory limits, must not prevent the participant from obtaining the highest rate of match available under the plan.[41] For example, if the plan provides for an employer matching contribution equal to the first 6 percent of compensation deferred by the participant, it would not be reasonable to restrict elective deferrals to a level less than 6 percent of compensation.

ADP Test Limit

A 401(k) plan must satisfy the ADP test under IRC §401(k)(3). The test prescribes a maximum average deferral rate for the group of HCEs who are eligible for the 401(k) arrangement for the plan year, the ADP test limit. If the HCEs' average deferral rate fails the ADP test, the excess contributions are refunded to the HCEs or other corrective action is taken.

Because of the ADP test, a portion of the elective deferrals made by an HCE, even though otherwise within the IRC §402(g) dollar limit, may be subject to refund if the ADP test is failed. An NHCE who participates in a 401(k) plan is not affected by the ADP test limit, so the NHCE's elective deferrals under a plan are limited only by the IRC §402(g) dollar limit and the other limits

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[40] Rev. Proc. 2008-50.

[41] Treas. Reg. §1.401(k)-3(b)(6), IRS Notice 98-52, Section V.B.1.c.ii.

discussed above. The ADP testing applies to all elective deferrals, regardless of whether they are pre-tax elective contributions or designated Roth contributions.

CORRECTION OF EXCESS DEFERRALS

When an individual's elective contributions for a calendar year exceed the applicable dollar limit under IRC §402(g), the individual has excess deferrals for income tax purposes.[42]

Distribution of the excess amount is the only method of correcting excess deferrals.[43] To avoid additional adverse tax consequences, the distribution deadline is April 15 of the calendar year following the calendar year in which the excess arose. For example, excess deferrals for 2019 should be distributed by April 15, 2020. The April 15 deadline is not postponed by extending the employee's federal income tax return.

The excess deferral must be adjusted for allocable earnings for the plan year in which the excess deferral arose, which may be positive (i.e., a net gain on the excess deferral while it was invested in the plan) or negative (i.e., a net loss on the excess deferral while it was invested in the plan).[44]

The rules for calculating allocable earnings are the same as the rules used for calculating earnings on excess contributions or excess aggregate contributions distributed to correct a failure of the ADP test or ACP test. These rules will be discussed in more detail in later chapters.

Plan's Determination of Excess Deferrals

The plan determines excess deferrals with reference to the IRC §401(a)(30) limit and, if applicable, the catch-up limit.

Because IRC §401(a)(30) is a qualification requirement, the plan may distribute the elective contributions that exceed the IRC §401(a)(30) limit.[45]

The plan will not distribute elective contributions that exceed the IRC §402(g) dollar limit to the extent the plan allows for catch-up contributions and the participant has not used up the catch-up limit. However, remember that catch-up contributions are determined by the plan at the plan level, taking into account all of the possible applicable limits under the plan. As a result, a participant might use up the catch-up limit by exceeding the IRC §415(c) limit, a plan-imposed limit or the ADP test limit. If so, it is possible that he or she will not be allowed to retain elective contributions in the plan, even though they do not exceed the IRC §401(a)(30) limit.

Corrective Distributions After the April 15 Deadline

A distribution described in IRC §402(g) (i.e., one made by the April 15 deadline) may be made notwithstanding any other provision of law. On the other hand, distributions of elective contributions from a 401(k) plan may be made after the April 15 correction deadline only when permitted under IRC §401(k)(2)(B)—in other words, only if there is another permissible

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[42] Treas. Reg. §1.402(g)-1(e)(1)(iii).
[43] IRC §402(g)(2).
[44] Treas. Reg. §1.402(g)-1(e)(5).
[45] Treas. Reg. §1.401(a)-30(a) and Treas. Reg. §1.402(g)-1(e)(1).

distributable event (such as the attainment of age 59½ or severance from employment). Thus, unless the 401(k) participant has satisfied a permissible distribution event under IRC §401(k)(2)(B), the excess deferrals cannot be distributed after April 15. An exception is made if the excess deferrals also cause the plan to violate the IRC §415 limit.

A plan may distribute excess deferrals at any time prior to the April 15 deadline after the excess is discovered, even if the discovery is in the same calendar year in which the excess amount was deferred from compensation.[46] For example, suppose the plan administrator discovers in November that a participant has already exceeded the IRC §402(g) dollar limit for that calendar year. The plan is able to determine immediately that there are excess deferrals (assuming that none of the excess is treated as a catch-up contribution) and may proceed with corrective action immediately.

Tax Consequences of Excess Deferrals

There are tax consequences associated with uncorrected excess deferrals under IRC §402(g).

Effect of Annual Exclusion Limit

IRC §402(g) is a limit on the amount of elective contributions that may be excluded from income for the year, so any elective contribution in excess of that limit (which includes the catch-up limit, if applicable) is automatically includible in income.

Income Inclusion Independent of Corrective Distribution

Under the IRC, income inclusion of excess deferrals occurs regardless of whether the excess deferrals are distributed on a timely basis. By limiting the exclusion to the §402(g) maximum, the IRC ensures that elective contributions in excess of that limit are includible in gross income.

Form W-2 Reporting Requirements

The IRS requires reporting of the entire amount of elective contributions on the Form W-2.[47] This will ensure that the IRS will be able to monitor the treatment of excess deferrals as taxable income. It also aides an individual in monitoring the limit when the individual participates in more than one elective contribution arrangement that is subject to IRC §402(g).

The amount of elective contributions reported on Form W-2 includes all elective contributions, regardless of whether they are catch-up contributions.[48] A catch-up eligible participant, however, will report in income only excess deferrals, meaning the amount by which his or her total elective contributions for the calendar year cause the employee to exceed the IRC §402(g) limit (including the applicable catch-up limit).

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[46] Treas. Reg. §1.402(g)-1(e)(3).
[47] IRS Notice 89-32, 1989-1 C. B. 671.
[48] Announcement 2001-93.

Corrective Distribution Subject to Separate Reporting by Plan

If excess deferrals are made to a plan, the violation is normally corrected by making a distribution of the excess, plus earnings. The corrective distribution is separately reported on Form 1099-R, not as part of the Form W-2, and does not affect the W-2 reporting requirement.

EXAMPLE 1-12. Tax Reporting of Excess Deferrals. An employee defers $20,200 for 2020. The employee is not catch-up eligible, so the 2020 IRC §402(g) dollar limit for the employee is $19,500. The excess deferral of $700 is includible in the employee's gross income for 2020, regardless of whether that excess deferral is distributed during 2020 or is distributed between January 1 and April 15, 2021. The employer reports $20,200 in Box 12 of the 2020 Form W-2. The excess amount of $700 is not reported as wages in Box 1 of the W-2 but is reported as taxable income on Form 1099-R. The employee must pick up $700 as additional income for 2020 because it exceeds the IRC §402(g) dollar limit for that year.

Taxation of Corrective Distributions

When a corrective distribution is made by the April 15 deadline, the excess deferrals are reported on Form 1099-R as taxable in the calendar year in which they were originally deferred (i.e., the deferral year).[49] By reporting the excess deferrals as taxable in the deferral year, the employee does not pay taxes twice on the excess amount. In other words, the taxation of the corrective distribution coincides with the same taxable year in which the individual's elective contributions exceeded the exclusion limit.

The allocable earnings included in the distribution are taxable in the distribution year (i.e., the calendar year in which the corrective distribution is actually made), even though the excess deferral amount is taxable in the deferral year. Thus, if the distribution year is different from the deferral year, the allocable earnings are taxed in a tax year that is different from the year in which the excess deferrals were taxed.

EXAMPLE 1-13. Timing of Taxation of Excess Deferrals. An employee's excess deferrals for 2020 (taking into account the catch-up limit, if applicable) total $500. The allocable earnings are $60. The corrective distribution is made on March 1, 2020. The excess deferrals ($500) are reported as income for 2020, but the allocable earnings ($60) are reported as income for 2021. If the corrective distribution had been made in 2020 (i.e., on or before December 31, 2020), the entire distribution, including the allocable earnings, would have been reported as income for 2020.

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[49] Treas. Reg. §1.402(g)-1(e)(8).

Reporting on Allocable Earnings That Result in a Net Loss

If the allocable earnings on excess deferrals are a net loss, the amount distributed will be less than the amount of the excess deferrals. In that case, the loss is reported as a bracketed amount on the "Other Income" line of the employee's federal income tax return.[50] The loss is reported for the distribution year, just like allocable earnings that is a net gain. The full amount of the excess deferrals must be reported as income for the deferral year.

EXAMPLE 1-14. Investment Loss on Excess Deferrals. An employee's excess deferrals for 2020 (taking into account the catch-up limit, if applicable) total $750. The allocable income is a net loss of $100. The plan distributes $650 on April 1, 2021. The employee must report the entire amount of the excess deferrals ($750) as income for 2020. The employee then takes a loss of $100 on his or her 2021 return, which is the tax year in which the distribution actually was made. The loss may be taken for 2021 only if the corrective distribution is made during that year (i.e., by December 31, 2020).

If there is a loss, only one Form 1099-R is required, regardless of whether the corrective distribution occurs in the deferral year or in the following calendar year.[51] The amount reported in the gross distribution box and in the taxable amount box is the amount of the distribution. A separate statement provided with the form must state that the entire amount of the excess deferrals, unadjusted for the loss, must be reported in income for the deferral year, and that a loss may be taken for the distribution year.

If You're Curious …

Distributions Made After April 15 Deadline

Remember that, if the distribution of excess deferrals does not occur before April 15 of the year following the year of deferral, they may only be distributed if a distributable event under IRC §401(k)(3) has happened. This may be in the year following the year of deferral, or several years later when the participant experiences a termination of employment or attainment of age 59½. When the excess deferrals are distributed at that time, the entire distribution must be included in income for the distribution year, even though the excess deferrals were included in gross income in the deferral year.[52] The practical effect of this rule is that the employee is taxed twice on the excess deferrals—once in the deferral year when he or she exceeded the IRC §402(g) dollar limit and a second time in the year the excess amount is distributed.

EXAMPLE 1-15. Failure to Distribute Excess Deferrals by April 15. JoAnne has excess deferrals for 2019 in the amount of $325. The plan does not distribute the excess

[50] IRS Notice 89-32, 1989-1 C.B. 671.
[51] Notice 89-32.
[52] Treas. Reg. §1.402(g)-1(e)(8)(iii).

amount by April 15, 2020. JoAnne receives a distribution of $370 on June 1, 2021, which represents the amount of the excess deferrals ($325) plus allocable earnings ($45). The following tax consequences apply to JoAnne.

For 2019 (i.e., the deferral year), JoAnne must include $325 in gross income, which represents the amount of her elective contributions for that year that exceeded the income exclusion limit under IRC §402(g).

For 2020, there are no tax consequences.

For 2021 (i.e., the distribution year), JoAnne must include $370 in gross income, which is the total distribution made to her, even though $325 of that amount was also included in her 2019 income.

For reporting purposes, only one 2021 Form 1099-R is issued to JoAnne with respect to the distribution made on June 1, 2021, because the entire amount is taxed in 2021. No Form 1099-R is issued with respect to the excess deferrals of $325 for 2019. That amount was shown as part of JoAnne's total elective contributions on her Form W-2 for 2019, and she is responsible for reporting the excess deferrals in gross income for that year.

Same Inclusion Rule Applies Even if Excess Deferrals Are Designated Roth Contributions

Unlike pre-tax elective contributions, designated Roth contributions are not excludable from gross income. Furthermore, special tax rules apply to qualified distributions from designated Roth accounts that allow the participant to receive payments attributable to designated Roth contributions (including investment earnings on those contributions) on a tax-free basis. Although designated Roth contributions are not pre-tax elective contributions, if they are excess deferrals under IRC §402(g), and the corrective distribution is not made by the appropriate April 15, they are not treated as after-tax employee contributions when they are distributed. This means that the double-taxation rule described above also applies to late corrective distributions of excess deferrals attributable to designated Roth contributions.[53]

Plan Does Not Report Excess Deferral Until Actually Distributed

The plan does not report the excess deferrals on a Form 1099-R until they are actually distributed. The IRS knows that excess deferrals have been contributed by the individual through the employee's Form W-2. In a separate box of the Form W-2, the employer must report the total amount deferred into the 401(k) plan. If that number exceeds the IRC §402(g) dollar limit (which includes the catch-up limit, if applicable), the IRS knows there is an excess. The employee's tax return preparer also uses this information to know how much of the elective contribution is not excludable from income for that year. If the employee does not use a tax return preparer, it is the employee's responsibility to know the tax rules and, of course, the instructions to the Form 1040 provide assistance. The same holds true when an employee participates in more than one employer's plan. The combined amounts reported as elective contributions on all the Forms W-2 issued to that individual for the calendar year will show

[53] IRC §402A(d)(3).

whether the exclusion limit has been exceeded, pursuant to the aggregation rules under IRC §402(g).

DESIGNATED ROTH CONTRIBUTIONS

Since January 1, 2006, a plan has been able to permit an employee to irrevocably designate all or part of his or her elective contributions as designated Roth contributions at the time that they are deferred to the plan. The plan must specifically authorize designated Roth contributions, and must maintain a separate designated Roth account, which reflects the value of the participant's designated Roth contributions (as adjusted for earnings and losses).[54]

Elective contributions that are designated Roth contributions are generally treated by the plan in the same manner as other elective contributions. For example, the limits described above – the IRC §§401(a)(30), 402(g) and 415 limits – apply to all elective contributions made by a participant, regardless of whether they are designated Roth contributions or pre-tax elective contributions.[55]

There are two primary differences between pre-tax elective contributions and designated Roth contributions:

1. The designated Roth contributions are not made on a pre-tax basis, so the portion of the elective contributions that is a designated Roth contribution is includible in the employee's gross income for the year of deferral; and
2. Distributions from the designated Roth account are subject to special tax rules.[56] In particular, if the participant meets two requirements, the total amount distributed (including both the after-tax contributions included in income as of the original contribution date and the earnings, which have never been subject to tax) is received by the participant completely tax free.[57]

To qualify for the special distribution rules, the participant must meet two requirements.

1. The designated Roth account in the 401(k) plan must meet the 5-year nonexclusion period rule.

   Under this rule, the first designated Roth contribution must have been made to the plan during a plan year that is at least five years prior to the year of the distributions.[58] (If a designated Roth amount is rolled over to the plan in a direct rollover from another qualified plan, the nonexclusion period from the payor plan applies to the participant's designated Roth account in the recipient plan).[59]

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[54] IRC §402A(c)(1).
[55] IRC §402A(a)(1).
[56] IRC §402A(d).
[57] Id.
[58] IRC §402A(d)(2)(B).
[59] Treas. Reg. §1.402A-1, Q&A-4(b).

2. The distribution must be on account of death or disability or occur after the participant attains age 59½.[60]

If these rules are met, the distribution is called a "qualified distribution," and the special tax treatment applies.

Regulations specify that certain types of distributions are never considered to be qualified distributions, even if the above requirements are met. In particular, deemed distributions of loans, corrective distributions and the taxable cost of current life insurance protection (i.e., PS-58 cost) are never qualified distributions.[61]

Distributions from a designated Roth account are considered to be pro rata contributions and earnings. Therefore, a distribution that is not a qualified distribution will contain some portion of earnings, and will, therefore, be partially taxable.[62]

MORE ABOUT CATCH-UP CONTRIBUTIONS

As discussed above, catch-up contributions are elective contributions that meet special requirements. Catch-up contributions may only be made by participants who are (or will be) age 50 or older by the end of the calendar year. In general, an elective contribution is not a catch-up contribution unless it exceeds one of the following limits:

- the IRC §402(g) dollar limit;
- the IRC §415 limit;
- a plan-imposed limit; or
- an ADP test limit, if applicable.

If one of these limits is exceeded and the affected participant is eligible to make catch-up contributions, the first method of correction is to recharacterize the elective deferral as a catch-up contribution.

Types of Plans That May Permit Catch-up Contributions

There are five types of plans (referred to as applicable employer plans in the regulations) that may permit employees to make additional elective contributions in the form of catch-up contributions. They are:

a. 401(k) plans [including SIMPLE 401(k) plans and safe harbor 401(k) plans];
b. 403(b) plans;
c. governmental 457(b) plans;
d. SARSEPs; and
e. SIMPLE IRAs.[63]

Elective contributions under these arrangements, other than the governmental 457(b) plans, are also subject to the IRC §402(g) dollar limit. In addition, all of the plans containing these

[60] IRC §402A(d)(2)(A).
[61] Treas. Reg. §1.402A-1, Q&A-11.
[62] Treas. Reg. §1.402A-1, Q&A-3.
[63] IRC §414(v)(6)(A) and Treas. Reg. §1.414(v)-1(g)(1).

arrangements, except for SIMPLE IRA plans and governmental 457(b) plans, are subject to the IRC §401(a)(30) limit.

The catch-up contribution limit is separate from the IRC §402(g) dollar limit and IRC §401(a)(30) limit, allowing an eligible participant to exceed such limit by an amount that does not exceed the catch-up contribution limit for the applicable calendar year.

Annual Catch-up Contribution Limit

Like the applicable dollar limit under IRC §401(a)(30) and IRC §402(g), the applicable dollar limit on catch-up contributions is applicable for the calendar year (i.e., tax year of the employee). The catch-up limit for 401(k) plans, 403(b) plans, governmental 457(b) plans and SARSEPs is different from the catch-up limit for SIMPLE 401(k) plans and SIMPLE IRAs.

For 2020, the catch-up limit for 401(k) plans, 403(b) plans, governmental 457(b) plans and SARSEPs is $6,500. The catch-up limit for SIMPLE plans is $3,000.

A participant's catch-up contributions cannot exceed the excess of the participant's IRC §415 compensation [i.e., compensation as defined in IRC §415(c)(3)] over any other elective contributions for the year that are made without regard to the catch-up provisions.[64]

This rule will rarely come into play because most participants will reach the catch-up dollar limit long before they defer 100 percent of their compensation. However, it is possible.

Applying the Catch-up Limit

From the individual's standpoint, catch-up contributions are simply the elective contributions that cause the individual's total for the calendar year to exceed the IRC §402(g) dollar limit, because the individual is concerned solely with the gross income exclusion limit under IRC §402(g). However, at the plan level, elective contributions might have to be treated as catch-up contributions before the IRC §402(g) dollar limit is exceeded. This is because the plan is required to comply not only with IRC §402(g), but also with the IRC §415 limits, plan-imposed limits and ADP testing limits. The catch-up limit at the plan level is in addition to other limits under the plan that might otherwise apply to an eligible participant's elective deferrals.

EXAMPLE 1-16. Catch-up Contributions in a 401(k) Plan. A 401(k) plan permits catch-up contributions. For 2020, a participant who satisfies the age 50 requirement makes elective contributions in the amount of $20,000. (Assume no other limits are exceeded.) Normally, the 401(k) plan would have to limit the participant's elective deferrals for 2020 to $19,500, pursuant to IRC §401(a)(30). However, through the catch-up limit, the participant is permitted to defer up to $26,000: $19,500 as elective deferrals permitted under the IRC §401(a)(30) limit and $6,500 as catch-up contributions.

Because this participant is catch-up eligible, the deferral amount of $20,000 is permissible. If the employee's elective deferrals for 2020 total $19,500 or less,

[64] IRC §414(v)(2)(A)(ii) and Treas. Reg. §1.414(v)-1(c)(1).

none of that amount is treated as catch-up contributions by the plan, unless another limit is exceeded.

If You're Curious …

Noncalendar Year Plans

Some plans operate on a plan year other than the calendar year. These plans must still monitor the catch-up limit on a calendar year basis, just like the IRC §§401(a)(30) and 402(g) dollar limits. However, the calendar year limit affected depends on whether the otherwise applicable limit that is being exceeded by an employee's elective contributions is determined on a calendar year basis or on the basis of a noncalendar period.

Timing of Whether Elective Contributions Are Catch-up Contributions

The plan's determination of whether any portion of a catch-up eligible participant's elective contributions are catch-up contributions generally is made at the end of a plan year (or end of the limitation year, in the case of the IRC §415 limits). Total elective contributions for that plan year are compared with the applicable limit.[65] An exception applies to statutory limits that are determined with reference to the participant's tax year or the calendar year [i.e., the IRC §401(a)(30) limit]. If a catch-up eligible participant exceeds an applicable limit for the plan year, then the amount of elective contributions for that year that exceeds that limit, up to the annual catch-up limit, is treated as catch-up contributions. If the plan year is not the calendar year, the applicable catch-up limit is the one for the calendar year in which the plan year ends (e.g., the catch-up limit for calendar year 2020 applies to a July 1, 2019, through June 30, 2020, plan year).

Special Rule: Determination of Catch-up Contributions When Limit is Based on the Participant's Tax Year or the Calendar Year

Catch-up contributions that arise because of an applicable limit that is based on the participant's tax year or the calendar year (in almost all cases, the participant's tax year is the calendar year) are determined at the time such limit is exceeded, because cumulative elective contributions for the plan year are not relevant in administering the limit.[66] For example, the IRC §401(a)(30) limit is such a limit because it prohibits a 401(k) plan from permitting a participant to make elective contributions for the calendar tax year that exceed the IRC §402(g) dollar limit in effect for that year. Once a catch-up eligible participant's elective deferrals for a calendar year reach the IRC §401(a)(30) limit, the plan must treat the elective contributions subsequently deposited first as catch-up contributions at the time contributed, regardless of whether the plan year in which they are made does not end until the next calendar year.

The amount of elective contributions that a plan may treat as catch-up contributions because they exceed the IRC §401(a)(30) limit for the calendar year may not exceed the annual catch-up limit for the calendar year. In the case of a plan with a noncalendar plan year, a portion of the calendar year's catch-up limit might have already been used by

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[65] Treas. Reg. §1.414(v)-1(b)(2)(i) and (c)(3).
[66] Treas. Reg. §1.414(v)-1(b)(2)(ii) and (c)(3).

reason of another limit (e.g., plan-imposed limit) for a plan year ending in the calendar year.

Elective Contributions that Exceed the Catch-up Limit, Too

When the annual catch-up limit is reached before the end of a calendar year, then any further elective contributions within that calendar year are simply treated by the plan as excess deferrals under IRC §402(g). Such excess deferrals must be corrected on a timely basis by the 401(k) plan in order to satisfy the qualification requirements of IRC §401(a)(30). For example, in calendar year 2020, the first $19,500 [i.e., the IRC §401(a)(30) limit for 2020] of a catch-up eligible participant's elective contributions are treated as regular elective deferrals, in the same way that the plan treats the elective deferrals of other participants. The next $6,500 of elective contributions for 2020 are treated as catch-up contributions. If the $6,500 annual catch-up limit for 2020 is reached before December 31, 2020, any subsequent elective contributions for that calendar year are treated as excess deferrals under IRC §402(g).

Considerations for Plans With Noncalendar Plan Years

If the plan year is not a calendar year, it is possible that an employee may exceed the plan-imposed limit for a period that includes part of two calendar years. However, because the determination of whether elective contributions exceed the plan-imposed limit is made at the end of the plan year, the portion of the elective contributions treated by the plan as a catch-up contribution is subject to the catch-up limit for the calendar year in which the plan year ends and affects the remaining catch-up limit for that calendar year with respect to the plan's application of the IRC §401(a)(30) limit for that year.[67]

EXAMPLE 1-17. Noncalendar Plan Year. Ruth, a catch-up eligible participant, has compensation of $100,000 for the plan year ending June 30, 2020. The plan-imposed limit is 10 percent of compensation which, for Ruth, is $10,000 for that plan year. To the extent Ruth's elective contributions exceed $10,000 for the plan year, such elective contributions are characterized as catch-up contributions (up to the applicable limit).

Ruth's elective contributions for the 2019-2020 plan year total $13,500. The amount over the plan limit (i.e., $3,500) may be treated as catch-up contributions for 2020 (i.e., the calendar year in which the June 30, 2020, plan year ends). Because the catch-up limit for 2020 is $6,500, the excess is treated in its entirety as catch-up contributions. This leaves, however, only $3,000 of the 2020 catch-up limit.

Of the elective contributions made by Ruth after June 30, 2020 that cause the employee's total elective contributions for calendar year 2020 to exceed the IRC §401(a)(30) limit, only $3,000 are treated as catch-up contributions (i.e., the $6,500 limit for 2020 reduced by the $3,500 of catch-up contributions for the June 30, 2020, plan year resulting from the plan-imposed limit), and the rest are treated by the plan as excess deferrals under IRC §402(g).

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[67] Treas. Reg. §1.414(v)-1(c)(3) and Examples 5 and 6 in Treas. Reg. §1.414(v)-1(h).

The final regulations clarify the interaction between catch-up contributions determined for non-calendar plan years and the IRC §401(a)(30) limit. First, for the calendar year that ends in the plan year, elective contributions that are catch-up contributions because they exceed the IRC §401(a)(30) limit for that calendar year are disregarded from the ADP test. Second, elective contributions that are catch-up contributions as of the last day of a noncalendar plan year (or noncalendar limitation year)[68] because they exceed the IRC §415(c) limit, an employer-provided limit, or the ADP test limit, are not taken into account to determine if the IRC §401(a)(30) limit is exceeded for the calendar year that begins in that plan year (or limitation year). EXAMPLE 1-18 below is based on examples provided in Treasury regulations.

EXAMPLE 1-18. Catch-up Contributions in Noncalendar Plan Years. A new 401(k) plan has a plan year ending October 31. For the plan year November 1, 2019, through October 31, 2020, the following elective contributions are made by Marta, one of the catch-up eligible HCEs.

Nov. 1 to Dec. 31, 2019: $2,700 of elective contributions
Jan. 1 to Oct. 31, 2020: $20,000 of elective contributions [$500 of which exceeds the 2020 IRC §402(g) dollar limit of $19,500]
Total elective contributions for plan year (Nov. 1, 2019 to Oct. 31, 2020): $22,700

This plan year falls partly in calendar year 2019 and partly in calendar year 2020. The elective contributions made in 2019 count toward the 2019 IRC §402(g) dollar limit, which was $19,000, to determine if any of those elective contributions are catch-up contributions by reason of IRC §402(g).

Let's assume that Marta only contributes to this plan. Her total amount of elective contributions for calendar year 2019 does not exceed $19,000, so none of the $2,700 is treated as catch-up contributions. The elective contributions made between January 1 and October 31, 2020, are counted toward the 2020 IRC §402(g) dollar limit, which is $19,500. Because Marta's elective contributions for that period total $20,000, $500 of that amount is treated as catch-up contributions for 2020.

This leaves the amount of Marta's elective deferrals that is included in the ADP test for the 2019–20 plan year as $22,200 (i.e., $22,700 total minus $500 catch-up).

The plan fails the ADP test for the plan year ending October 31, 2020. The plan corrects through the corrective distribution method. The ADP test limit for Marta determined under ADP testing is $16,300.

Marta's excess contributions total $5,900 (i.e., $22,200 included in the ADP test, as determined above, minus $16,300 ADP test limit). The entire $5,900 is recharacterized as catch-up contributions for 2020.

After the application of the ADP test limit, Marta's remaining unused catch-up limit for the rest of 2020 is $100 (i.e., $6,500 catch-up limit minus $500 in excess of the IRC

[68] Treas. Reg. §1.414(v)-1(h), Examples 5 and 6.

§402(g) dollar limit through October 31, 2020, minus $5,900 in excess of the ADP test limit).

Catch-up Limit is Exceeded

There is no statutory mechanism for a plan to correct excess catch-up contributions made by a catch-up eligible participant (i.e., elective contributions that exceed the applicable limit by more than the catch-up limit). It appears reasonable to treat such amounts as excess amounts under the applicable limit being exceeded.

Excess Deferrals Under IRC §402(g)

If an employee's elective contributions for the calendar year exceed the IRC §401(a)(30) limit by more than the catch-up limit, the amount that exceeds the catch-up limit is treated by the plan as an excess deferral under IRC §402(g) and distributed in accordance with the rules prescribed by IRC §402(g).[69] The refund of such excess deferrals enables the plan to comply with IRC §401(a)(30), thus protecting the plan's qualification.

If the catch-up limit is exceeded because of participation in multiple plans, but the plan-imposed limit under any individual plan is not exceeded, the excess amount is not treated as catch-up contributions, but also is not considered to be a violation of the plan-imposed limit. Such amount is also included in the applicable ADP test.[70]

Amounts Exceeding IRC §415(c), But Not IRC §402(g)

If a catch-up eligible participant's elective contributions cause the participant's annual additions to exceed the IRC §415(c) limit by more than the catch-up limit, but the elective contributions have not exceeded the IRC §402(g) dollar limit, the amount of the elective contributions that cause the catch-up limit to be exceeded may be treated as an excess annual addition under IRC §415(c). This is also a plan qualification problem and must be corrected using the IRS's correction programs under EPCRS.

Plan-Imposed Limit, But Not Statutory Limit, Exceeded

If a catch-up eligible participant's elective contributions exceed a plan-imposed limit by more than the catch-up limit, but the excess does not cause the IRC §402(g) dollar limit or the IRC §415(c) limit to be exceeded, the amount that exceeds the catch-up limit is treated as an operational violation of the terms of the plan, and may be corrected in accordance with the IRS' EPCRS correction procedures. Alternatively, the employer might be able to amend the plan to retroactively increase the plan-imposed limit through the VCP procedures outlined under the EPCRS program.

Other Administrative Issues for Plans that Permit Catch-up Contributions

Besides exempting catch-up contributions from the limits described above, the IRC provides that the making of (or right to make) catch-up contributions shall not cause the plan to fail to satisfy a number of qualification requirements. These requirements include: IRC §401(k)(3) [ADP test], IRC §401(k)(11) [SIMPLE 401(k) rules], IRC §403(b)(12)

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[69] Treas. Reg. §1.402(g)-2(a).
[70] Treas. Reg. §1.414(v)-1(f)(2).

[nondiscrimination testing for 403(b) plans], IRC §408(k) [SARSEP nondiscrimination test], IRC §410(b) [coverage testing], IRC §401(a)(4) [non-discrimination testing] or IRC §416 [top-heavy rules].[71]

ADP Testing

The reference to the ADP test means that, if the ADP test is failed, a portion of an HCE's elective deferrals are subject to treatment as catch-up contributions if:

1. the HCE is a catch-up eligible participant, and
2. the HCE has an unused catch-up limit for the calendar year in which the plan year ends (i.e., the elective deferrals made by the HCE either do not exceed any statutory or plan-imposed limit, or exceed such limits by an amount less than the annual catch-up limit).[72]

In other words, the results of the ADP test determine whether there is an ADP test limit on the HCEs, above which elective deferrals made by a catch-up eligible HCE are to be treated as catch-up contributions to the extent the catch-up limit has not already been used up.

Coverage Testing Issues Under IRC §410(b)

If the plan is relying on the average benefit test to pass coverage, and elective contributions are included in that test, as required by Treas. Reg. §1.410(b)-7(e), elective contributions that are catch-up contributions made in the current plan year would be excluded.[73]

Nondiscrimination Testing Under IRC §401(a)(4)

How should catch-up contributions be factored into any nondiscrimination test performed under IRC §401(a)(4)? If the general test (also known as the rate group test) under Treas. Reg. §1.401(a)(4)-2(c) is being applied to determine whether the amount of employer contributions (other than elective contributions and employer matching contributions) or the amount of employer-provided benefits is nondiscriminatory, and the average benefit test is being used to perform that general test, the same rules as described above in relation to coverage testing apply.

Catch-up Contribution Rights Not Tested as Separate Benefit, Right or Feature

The right to make catch-up contributions is not tested as a separate benefit, right or feature under Treas. Reg. §1.401(a)(4)-4. Thus, allowing employees to make catch-up contributions is not considered to be discriminatory, even though only employees over age 50 can be eligible, even if all of the employees who satisfy the age-50 rule are HCEs.[74] However, a universal availability test must be satisfied. Under this test, a plan is treated as failing to satisfy IRC §401(a)(4) unless all catch-up eligible participants have the same election rights available to them with respect to catch-up contributions.[75]

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[71] IRC §414(v)(3)(B).
[72] Treas. Reg. §1.414(v)-1(d)(2)(iii).
[73] Treas. Reg. §1.414(v)-1(d)(3)(ii).
[74] Treas. Reg. §1.414(v)-1(d)(4).
[75] IRC §414(v)(4), Treas. Reg. §1.414(v)-1(e).

Top-Heavy Rules

The reference to IRC §416 in the catch-up rules presents two issues:

1. how the top-heavy minimum contribution requirements are affected by catch-up contributions, and
2. how the determination of whether the plan is top-heavy is affected by catch-up contributions.

Catch-up contributions made by key employees for the current plan year are disregarded in determining the highest contribution rate for the key employees under IRC §416(c)(2)(B) for top-heavy purposes.[76] This could affect the employer's minimum contribution liability to the non-key employees.

Catch-up contributions made in the plan year being tested are also disregarded for determining whether account balances of key employees constitute more than 60 percent of the total accounts (i.e., in determining if the plan is top-heavy).[77] However, catch-up contributions made for prior plan years are included in the participant's account for this purpose. Remember that, for all plan years except the first year, the top-heavy ratio is based on account balances as of the end of the prior year (i.e., the determination date for top-heavy testing purposes). Therefore, all elective contributions made in prior plan years, including catch-up contributions, are included in those account balances.

Because the regulations do not permit the plan to disregard the value of catch-up contributions made in prior plan years to determine whether a plan is top-heavy, there is no reason to keep a separate subaccounting of the value of the catch-up contributions (i.e., the aggregate of catch-up contributions, as adjusted for investment earnings).

Some 401(k) plans apply an elective contribution limit on a payroll period basis, or a monthly or quarterly basis, or for the portion of the plan year that the participant is eligible for the 401(k) arrangement. Nonetheless, the extent to which a catch-up eligible participant's elective contributions exceed the plan-imposed limit is determined on a plan year basis.[78] The sum of the limits for each compensation period included in the plan year is compared to the total elective contributions made by the catch-up eligible participant for the plan year to determine whether any portion of the participant's elective contributions are catch-up contributions.

When a plan limits elective contributions as a percentage of compensation or through a limitation other than a statutory limit, the plan also needs to provide a way in which a catch-up eligible participant can elect to exceed that limit, so that the catch-up eligible participant has an effective opportunity to make catch-up contributions.

Plan-Imposed Limits on Deferrals as Rationale for Catch-up Contribution

To be taken into account for catch-up contribution purposes, a plan-imposed limit is any limit on the elective deferrals that an employee can make which is "contained in the terms of the plan, but

[76] Treas. Reg. §1.414(v)-1(d)(3)(i).
[77] Treas. Reg. §1.414(v)-1(d)(3)(i).
[78] Treas. Reg. §1.414(v)-1(b)(2)(i)(A).

which is not required under the IRC."[79] An example of a plan-imposed limit would be a provision in a 401(k) plan that limits elective deferrals to 10 percent of compensation for the plan year. An employee's elective deferrals will be characterized as catch-up contributions (up to the annual catch-up limit) to the extent that the elective deferrals for the plan year exceed that plan-imposed limit, unless one of the statutory limits described above is reached first. In other words, the first statutory or plan-imposed limit reached is the level above which elective deferrals may be treated as catch-up contributions.

EXAMPLE 1-19. Plan-Imposed Limit Applied on Annual Basis. A calendar year 401(k) plan provides that a participant's elective deferrals for a plan year may not exceed 10 percent of compensation for the plan year. The plan permits catch-up contributions. Consider the following two catch-up eligible participants for the 2020 plan year end (IRC §402(g) dollar limit is $19,500 and catch-up limit is $6,500).

Michael: His compensation is $200,000 and his plan limit is $20,000 (i.e., 10% x $200,000). Michael reaches the IRC §402(g) dollar limit before he reaches the plan limit. Thus, his catch-up contributions for 2020 are the elective deferrals that exceed $19,500 (up to the catch-up limit). If Michael defers $20,000 for the year, he will have exceeded the IRC §402(g) dollar limit (prior to considering catch-up contributions, but not the plan-imposed limit). In that case, he will have deferred $19,500 under IRC §402(g) [which also does not violate the plan's limit] and $500 of the $6,500 catch-up limit. In this case, if Michael continues to defer in 2020, it will be in excess of $19,500 and those contributions will be subject to the remaining catch-up limit (i.e., $6,000).

Arthur: His compensation for is $90,000. Although the IRC §402(g) dollar limit is $19,500, Arthur's plan-imposed limit is only $9,000 (i.e., 10% x $90,000). Arthur reaches the plan limit before he reaches the IRC §402(g) dollar limit, so any elective deferrals he makes for the 2020 plan year that exceed $9,000 are treated as catch-up contributions (up to the catch-up limit). If Arthur's elective deferrals are less than $9,000, then no portion of his elective deferrals is treated by the plan as a catch-up contribution (subject to the ADP test limit, if Arthur is an HCE under the plan). However, if Arthur's elective deferrals exceed $9,000 this year, every dollar is in excess of the plan limit and is classified as a catch-up contribution. This means that elective deferrals above $15,500 (i.e., plan-imposed limit of $9,000 plus $6,500 catch-up limit) would exceed the catch-up limit and Arthur's elective deferrals above the combined plan-imposed limit and the catch-up limit would cause the plan to violate its plan-imposed limit.

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[79] Treas. Reg. §1.414(v)-1(b)(1)(ii).

Required Plan Documentation

A plan may not treat elective contributions as catch-up contributions unless the plan permits. IRC §414(v)(1) provides that a plan is not treated as failing to satisfy any other IRC requirements solely because the plan permits an eligible participant to make catch-up contributions.

Neither IRC §414(v) nor the regulations issued thereunder require any formal notice to participants with respect to the plan's catch-up contributions. However, one of the conditions for making catch-up contributions available to participants is that the participants have an effective opportunity to make such contributions.[80] If a catch-up eligible participant has not been notified of his or her right to make these contributions, the effective opportunity requirement might not be satisfied. For example, a catch-up eligible participant who would otherwise be limited by a plan-imposed limit would not know that an additional deferral election could be made to take advantage of the catch-up limit unless the plan had communicated that right to the participant. Providing a Summary Plan Description (SPD) of the plan features would be ample notification.

If You're Curious …

AGGREGATION RULES

The limits on elective contributions and catch-up limits are subject to aggregation rules. Aggregation for IRC §402(g) purposes is applied at the individual (i.e., employee) level, whereas aggregation for IRC §401(a)(30) purposes is applied at the employer level.

Aggregation Rules Under IRC §402(g)

The maximum exclusion allowed under IRC §402(g) applies to an individual on all of his or her elective contributions that are subject to IRC §402(g) [i.e., elective contributions in 401(k) plans, 403(b) plans, SARSEPs and SIMPLE IRA plans]. If the employee contributes to more than one deferral arrangement that is subject to the exclusion limit, the limit applies to all elective contributions made in the same taxable year of the individual (usually the calendar year). A greater exclusion limit applies to a catch-up eligible individual and corresponding aggregation rules apply to determine if that higher limit is exceeded. The individual is responsible for determining whether the IRC §402(g) exclusion limit has been exceeded and taking appropriate corrective steps.

Aggregation for IRC §402(g) purposes applies even if unrelated employers maintain the plans to which the employee made elective contributions. Unrelated employers are employers that are not part of the same controlled group of businesses, as described in IRC §414(b) or (c), and are not part of the same affiliated service group, as described in IRC §414(m).

EXAMPLE 1-20. Participation in 401(k) Plan and 403(b) Plan in Same Year. Dr. Fellows participates in a 401(k) plan maintained by her professional corporation. She also teaches at a hospital and participates in the hospital's 403(b) plan. The professional corporation and the hospital do not constitute a controlled group of businesses or an

[80] Treas. Reg. §1.414(v)-1(e)(1)(i).

affiliated service group. Dr. Fellows' elective contributions under the 401(k) arrangement and her salary reduction contributions under the 403(b) plan are aggregated to determine if she exceeds the IRC §402(g) exclusion limit for a calendar year, even though the professional corporation and the hospital are not related employers.

EXAMPLE 1-21. Changing Employment During the Year. Jason participates in the Company M 401(k) Plan from January 1 through May 31, during which time Jason makes elective contributions to the Company M plan. Jason quits on May 31 and goes to work for Company N, which is not related to Company M. Company N also has a 401(k) plan and an employee is eligible to participate after three months of employment. Jason becomes eligible for the Company N 401(k) Plan as of September 1 of the same calendar year during which he left Company M, and begins making elective contributions under the Company N plan. His elective contributions to the Company N plan are aggregated with his elective contributions made in the same calendar year to the Company M plan to determine if he has exceeded the exclusion limit under IRC §402(g) for that calendar year.

For a catch-up eligible individual, the annual IRC §402(g) dollar limit is increased by the annual catch-up contribution limit. A catch-up eligible individual is also allowed only one catch-up limit under IRC §402(g) per taxable year. For example, if an individual works the first six months of 2020 for a company that maintains a 401(k) plan and the second six months for an unrelated organization that maintains a 403(b) plan, the individual's maximum elective deferrals that are excludable from income pursuant to IRC §402(g), assuming the individual is a catch-up eligible participant, may not exceed $26,000 for 2020.

To determine the increased exclusion limit under IRC §402(g) for catch-up eligible individuals, use the general catch-up limit. For example, the limit for 2020 is $6,500.

The plans that receive an individual's elective contributions apply the IRC §401(a)(30) limit and the catch-up rules, without regard to the individual's characterization of the elective contributions under IRC §402(g).

EXAMPLE 1-22. Individual Defers to Two Unrelated Plans. Regina, who is catch-up eligible, earns $50,000 for the first six months of compensation in 2019 and participates in a 401(k) plan, and earns $80,000 for the second six months of compensation in 2019 and participates in a 403(b) plan. The companies that maintain the two plans are not related. Regina elects a 15 percent deferral rate under both plans, resulting in elective contributions of $7,500 (i.e., 15% x $50,000) in the 401(k) plan and $12,000 (i.e., 15% x $80,000) in the 403(b) plan, for a total of $19,500 for 2019. Assume the elective contributions made to each plan do not exceed any statutory limit or plan-imposed limit under either plan and none of the elective contributions to the 401(k) plan exceeds the ADP test limit. Thus, even if either or both of these plans contain catch-up provisions, none of the elective contributions is treated by those plans as catch-up contributions.

Nonetheless, Regina has exceeded the basic exclusion limit under IRC §402(g) with respect to her total elective contributions for 2019. The total of the elective contributions is $19,500. Regina may exclude the entire $19,500 from gross income [i.e., $19,000 regular limit under IRC §402(g) plus $500 of the $6,000 catch-up limit, pursuant to IRC

§402(g)]. In effect, then, Regina has treated $500 of her elective contributions as catch-up contributions, even though neither plan treats any of the elective contributions as catch-up contributions. If the total amount of elective contributions exceeded $25,000, then the amount above $25,000 would be excess deferrals under IRC §402(g), and Regina would need to request a distribution from one of the plans.

IRC §414(v) and the regulations under that section outline operational rules under which a plan determines whether any portion of a catch-up eligible participant's elective contributions is treated by the plan as a catch-up contribution. Such treatment, however, does not affect the individual's determination of whether the exclusion limit under IRC §402(g) has been exceeded. The individual simply aggregates all elective contributions made in a calendar year that are subject to IRC §402(g) and determines whether that total exceeds the sum of the regular IRC §402(g) dollar limit plus the catch-up limit.

EXAMPLE 1-23. Recharacterization of Excess Deferrals as Catch-up Contributions by Two Unrelated Plans. Two 401(k) plans maintained by unrelated employers have plan years ending December 31. Leo works for both companies during 2019. Leo's 2019 elective contributions total $8,200 under Company A's plan and $11,800 under Company B's plan. Leo is an HCE under both plans and each plan fails the ADP test. Leo is a catch-up eligible participant. Company A's plan determines that Leo's allocable refund under IRC §401(k)(8)(C) is $3,000. Company B's plan determines that Leo's allocable refund under IRC §401(k)(8)(C) is $4,000. Neither plan makes a refund to Leo because each plan recharacterizes the affected elective contributions as catch-up contributions. Leo's total amount of elective contributions for 2019 is entirely excludable under IRC §402(g) even though the sum of the amounts treated as catch-up contributions under the two plans ($7,000) exceeds the $6,000 catch-up limit in effect for 2019.

Although neither plan could treat more than $6,000 of elective contributions as catch-up contributions, the combined amount treated as catch-up contributions under the two plans is permitted to exceed $6,000, because the plans are maintained by unrelated employers and are not aggregated. Leo's elective contributions for 2019 total $20,000, which does not exceed the $25,000 maximum exclusion permitted under IRC §402(g) [i.e., $19,000 limit under IRC §402(g) plus $6,000 catch-up limit under IRC §402(g)].

If an individual's elective contributions under two or more plans exceed the exclusion limit under IRC §402(g) on a combined basis, the individual must decide which plan holds the excess. Notice must be given to that plan so a timely distribution can be made. The plans will not have internal mechanisms to oversee the individual's combined amount of elective contributions, unless those plans are maintained by the same employer or by employers who are part of a single controlled group.

IRC §402(g) provides that the individual must notify a plan not later than March 1 following the calendar year for which the excess deferral was made. The March 1 deadline is considered a sufficient time for the plan to be able to make the corrective distribution by the April 15 deadline. If notice is given after March 1, the plan could certainly make the distribution anyway but, if the plan is unable to make the corrective distribution by April 15, the distribution restrictions under IRC §401(k)(2) might prohibit the distribution.

Disqualification Protection

Excess deferrals under IRC §402(g) will not disqualify a plan under IRC §401(a)(30) if the excess is due to the aggregation of the individual's elective contributions with a deferral arrangement maintained by an unrelated employer. This is because the IRC §401(a)(30) limit is applied aggregating only elective contributions made to plans of related employers. In EXAMPLE 1-21, if Jason's elective contributions into Company N’s plan cause him to exceed the exclusion limit under IRC §402(g) because of the aggregation of his elective contributions under Company M's plan, neither plan is disqualified because those companies are unrelated employers. This is true even if no timely corrective distribution is made because Jason fails to notify one of the plans about his excess deferrals.

Aggregation of Plans of Same or Related Employer

Because the IRC §401(a)(30) limit is applied at the plan level, aggregation rules are applied at the employer level to determine whether the elective contributions under more than one plan need to be aggregated to determine if the limit has been exceeded. If an employer maintains more than one plan that is subject to the IRC §401(a)(30) limit, an eligible employee’s elective contributions under all such plans must be combined and, if the limit is exceeded, the excess deferrals must be refunded to maintain the plan’s qualification. Similar aggregation rules apply to the catch-up limit.

EXAMPLE 1-24. Two 401(k) Arrangements Maintained by One Employer. A corporation maintains two separate 401(k) plans, one for salaried employees and the other for hourly-paid employees. If an employee’s job classification changes, the employee’s participation is shifted to the plan maintained for the new job classification, starting with the payroll period following the change. The plan year of both plans is the calendar year. For 2020, Manuel is an hourly paid employee for the first seven months and a salaried employee for the last five months, due to a change in his employment responsibilities. Manuel’s elective contributions for 2020 total $10,000 in the hourly-paid plan and $10,000 in the salaried plan, for a grand total of $20,000.

Although Manuel’s elective contributions in any one of the plans have not exceeded the IRC §401(a)(30) limit for 2020 ($19,500), the plans are required to aggregate Manuel’s elective contributions to determine whether the limit is exceeded. Thus, to maintain their qualification, the plans must refund Manuel’s excess deferrals. His combined elective contributions exceeded the IRC §401(a)(30) limit by $500. If Manuel is a catch-up eligible participant, those elective contributions might be catch-up contributions and would not need to be refunded.

Related Employers

Certain related employers, such as employers that constitute a controlled group of businesses, as defined in IRC §§414(b) or (c), are treated as a single employer when applying IRC §401(a)(30). Employers that are related by reason of the affiliated service group rules under IRC §414(m) are not treated as a single employer for IRC §401(a)(30) purposes. IRC §414(m)(4) does not list IRC §401(a)(30) among the employee benefit requirements that must be satisfied on a single-employer basis by an affiliated service group. Compare this to IRC §§414(b) and (c) (the IRC sections that govern controlled

groups), which cross-reference IRC §401 in its entirety, thus, encompassing IRC §401(a)(30).

Aggregation Rules for Catch-up Limit

IRC §414(v)(2)(D) provides employer-level aggregation rules for applying the annual catch-up limit. The aggregation rules applicable to the catch-up limit apply to all related employer situations, including the affiliated service group rules under IRC §§414(m) and 414(o). This is because IRC §414(v) (2)(D) specifically refers to IRC §§414(b), 414(c), 414(m) and 414(o), unlike IRC §401(a)(30), as discussed above.

Multiple Plans by Same Employer (or Related Group)

When any limit that is used to identify catch-up contributions is applied on an aggregate basis to more than one plan maintained by an employer, the combined catch-up contributions under all such plans may not exceed a single annual catch-up limit. If two or more defined contribution plans maintained by the same employer or related group are aggregated for IRC §415(c) purposes, the combined amount of the participant's catch-up contributions [i.e., those that are exempt from the IRC §415(c) limit] may not exceed the annual catch-up limit in effect for the calendar year in which the plan's limitation year ends.

Application of Plan-Imposed Limit to Aggregated Plans

If two or more plans are aggregated for purposes of the catch-up rules, and more than one of the plans contains a plan-imposed limit on elective contributions, each plan may allow catch-up eligible employees to exceed its respective plan-imposed limit. However, if, on a combined basis, the employee's catch-up contributions so determined exceed the catch-up limit, the excess must not be treated as catch-up contributions and must be included in the ADP test. To determine how much of the elective contributions are in excess of the respective plans' limits are catch-up contributions, the plans may use any reasonable method that is consistent with the manner in which elective contributions were made under the plans. If the plan years of the plans are different, amounts in excess of the plan-imposed limit for the plan with the plan year that ends first in the calendar year will be treated first as catch-up contributions, because catch-up contributions in excess of the plan-imposed limit are calculated as of the end of the plan year.

If the right to make elective contributions in excess of the plan's limit results in a portion of the elective contributions in excess of such limit not being treated as catch-up contributions because of this aggregation rule, the plan must treat such right as a separate right or feature that must be available on a nondiscriminatory basis, in accordance with Treas. Reg. §1.401(a)(4)-4.

Multiple Employer Plans

Multiple employer plans (i.e., plans maintained by two or more unrelated employers), as described in IRC §413(c), apply IRC §401(a)(30) as if each employer maintains a separate plan .

SUMMARY OF LIMITS

The interplay between the individual §402(g) limit, the plan-level §401(a)(30) limit and the catch-up contribution limit can be illustrated and summarized by the following table.

All of the examples below assume a 2020 year, that Plan A and Plan B are plans of unrelated employers and that no corrective distributions are made on a timely basis.

Situation	Deferrals to Plan A	Deferrals to Plan B	Total Elective Deferrals	Resolution
Participant is under age 50, defers to one plan	$18,000	$0	$18,000	No violations
Participant is under age 50, defers to one plan and exceeds §402(g) limit	$20,000	$0	$20,000	Participant exceeds §402(g) limit and has taxable income of $500; Plan A violates §401(a)(30) and is subject to disqualification
Participant is age 50+, defers to one plan and exceeds §402(g) limit, but not catch-up limit	$22,500	$0	$22,500	Participant exceeds normal §402(g) limit, but not the $6,500 catch-up limit; no violations
Participant is age 50+, defers to one plan and exceeds both §402(g) and catch-up limits	$26,500	$0	$26,500	Permissible deferrals are $19,500 + $6,500 catch-up ($26,000 total); Participant exceeds §402(g) limit and has taxable income of $500; Plan A violates §401(a)(30) and is subject to disqualification
Participant is under age 50, defers to two plans	$15,000	$3,000	$18,000	No violations
Participant is under age 50, defers to two plans and exceeds §402(g) limit in total	$15,000	$5,000	$20,000	Participant exceeds §402(g) limit and has taxable income of $500; neither plan violates §401(a)(30) because limit in neither plan is violated
Participant is age 50+, defers to two plans above total §402(g) limit, but not catch-up limit; §402(g) not exceeded in any plan	$15,000	$5,000	$20,000	Participant exceeds normal §402(g) limit but not $6,500 catch-up limit; participant considers $500 to be catch-up contributions, but neither plan considers any deferrals to be catch-up contributions

Situation	Deferrals to Plan A	Deferrals to Plan B	Total Elective Deferrals	Resolution
Participant is 50+, defers less than §402(g) limit to both plans, but violates §402(g) when deferrals are considered together	$15,000	$11,500	$26,500	Participant exceeds §402(g) and catch-up limit ($26,000 total); participant has $500 of taxable income; neither plan violates §401(a)(30); Participant has used up $6,500 catch-up limit, but neither plan considers any deferrals to be catch-up contributions
Participant is age 50+, defers more than §402(g) limit to one plan, but total deferrals are within catch-up limit	$20,000	$5,000	$25,000	Participant exceeds §402(g) limit, but not $6,500 catch-up limit; Plan A considers $500 to be catch-up contributions; Plan B considers no deferrals to be catch-up contributions; participant considers $5,000 of total contribution to be catch-up contributions

1.06: After-Tax Employee Contributions

A qualified plan may provide for after-tax employee contributions (that are not designated Roth contributions), as well as employer contributions. After-tax employee contributions are made on an after-tax basis and may be voluntary (at the employee's discretion) or mandatory (required as a condition for accruing benefits). Qualified plans of any type may allow (or require) after-tax employee contributions, even those that are not permitted to contain 401(k) deferral provisions.

A defined contribution plan generally maintains a separate account for after-tax employee contributions and earnings on those contributions, whether the contributions are voluntary or mandatory.

HOW AFTER-TAX EMPLOYEE CONTRIBUTIONS ARE MADE

A plan may accept after-tax employee contributions by having the participant write a check to the plan (or to the employer, which is then contributed by the employer to the plan), or by offering payroll deduction payments. If the payroll deduction method is used, the amounts are not deducted for federal tax purposes (i.e., they are includible in the employee’s gross income), because the contributions are made on an after-tax basis.

Whether the after-tax employee contribution is deducted from the employee's paycheck or a check is written to the employer, the employer is required to transmit that contribution to the trust as soon

as possible, under the same rules as apply to 401(k) elective contributions, which are discussed above.

MATCHING CONTRIBUTIONS ON AFTER-TAX EMPLOYEE CONTRIBUTIONS

A defined contribution plan that allows for after-tax employee contributions may include an employer matching contribution formula that applies to the after-tax employee contributions. If a plan that accepts after-tax employee contributions also includes a 401(k) arrangement, the employer matching contribution formula may apply to both elective contributions and after-tax employee contributions, or just to one type of contribution. The terms of the plan will control.

LIMITS ON AFTER-TAX EMPLOYEE CONTRIBUTIONS

The plan may provide limitations on after-tax employee contributions. For example, the plan may provide that a participant's after-tax employee contributions in the plan year cannot exceed 6 percent of compensation for the plan year. After-tax employee contributions also are subject to the annual additions limit under IRC §415(c) and, except in the case of mandatory employee contributions under a defined benefit plan, the nondiscrimination testing requirements of IRC §401(m).

1.07: Matching Contributions

A 401(k) plan may provide for an employer matching contribution based on all or a portion of the elective contributions. The matching formula also may be discretionary, so that the employer will determine the desired annual matching contribution rate each year.[81] The employer contributes the amount determined by the employer matching contribution formula for each participant and that amount is allocated to the participant's account.

If the plan includes an employer matching contribution formula, then the plan also must include an allocation formula to determine how the employer matching contributions are allocated among the eligible participants. The following factors might be taken into consideration in designing an employer matching contribution formula:

1. whether the employer wants discretion in setting the amount each year;
2. whether the formula should be tiered (i.e., a different rate of match for different levels of elective contributions); and
3. whether the amount of the match should be capped to a specific percentage of compensation or a specific dollar amount.

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[81] Treas. Reg. §1.401(m)-1(f)(12).

Generally, an employer matching contribution acts as an incentive to participants to defer compensation to the 401(k) plan.

MATCHING CONTRIBUTION FORMULAS

The following examples describe some common matching formulas.

EXAMPLE 1-25. Specific Rate of Match. A plan's employer matching contribution formula is 50 percent of elective contributions. Under this formula, the rate of match (i.e., 50 percent) is predetermined. If a participant's elective contributions for the plan year total $1,000, his or her account would receive an allocation of $500 in employer matching contributions. The allocation formula would require the administrator to allocate $500 of the employer's matching contribution to the participant's account to reflect the participant's share of employer matching contributions.

EXAMPLE 1-26. Cap on Match. A plan's employer matching contribution formula is 25 percent of elective contributions, taking into account only elective contributions up to 3 percent of the participant's compensation. To illustrate this formula, suppose a participant's compensation is $100,000.

The participant defers $4,000 under the 401(k) arrangement. Because 3 percent of compensation is $3,000, and the participant's elective contributions exceed that amount, the 25 percent employer matching contribution is applied only to the first $3,000 of the elective contributions. The employer matching contribution is $750 (i.e., 25% x $3,000).

The allocation formula would require the administrator to allocate $750 of the employer's matching contribution to the participant's account to reflect his or her share of employer matching contributions. A variation of the capped contribution formula is to specify a dollar amount as the cap. For example, the plan might provide for an employer matching contribution of 25 percent of elective contributions, with a cap of $1,000 on the employer matching contribution (i.e., only the first $4,000 of elective contributions for the plan year are matched at the 25 percent rate).

EXAMPLE 1-27. Tiered Match Formula. A plan's employer matching contribution formula is 100 percent of elective contributions up to 2 percent of compensation, 50 percent of the next 2 percent of compensation deferred and 25 percent of the next 2 percent of compensation deferred. This is known as a tiered formula, because the participant's employer matching contribution is a different percentage of his or her elective contributions depending on what portion (or tier) of the participant's compensation is being deferred.

Suppose Joshua's compensation is $50,000. Each tier is defined in 2 percent increments of the participant's compensation or $1,000 increments for Joshua. Under the formula, Joshua is entitled to an employer matching contribution of 100 percent on the first $1,000 deferred, 50 percent on the next $1,000 deferred and 25 percent on the third $1,000 deferred.

Suppose Joshua's elective contribution for the plan year total $2,500. The employer would match 100 percent (or $1,000) on the first $1,000, 50 percent (or $500) on the second $1,000 and 25 percent (or $125) on the last $500. The allocation formula would require the administrator to allocate a total of $1,625 of the employer's matching contribution to Joshua's account to reflect his share of employer matching contributions.

An employer matching contribution formula based on a percentage of compensation might use a compensation period that is less than the entire plan year to calculate the employer matching contribution liability. This could arise when an employee is eligible for only part of the year, when the employee actually defers for only part of the year, or a combination of both. When an employee is eligible for only part of the year, a plan might disregard the participant's compensation for the portion of the year during which he or she is not eligible to receive an employer matching contribution. In addition, some employers want to disregard the employee's compensation for periods during which he or she is not actually deferring under the plan (i.e., excluding compensation earned in payroll periods for which no elective contributions are withheld). If the employer wants to fund matching contributions along with the elective contribution deposits (a pay-as-you-go approach), it may prefer to have the plan written this way. The plan document should be written in a manner that clearly describes how the employer matching contribution is calculated. If the document is not clear, the plan administrator is usually charged under the plan document with the responsibility of interpreting the written language.

EXAMPLE 1-28. Effect of Partial Year of Eligibility. A 401(k) plan provides a $1-for-$1 (i.e., 100 percent) match on the first 4 percent of compensation deferred. Frank earns $10,000 for each quarter of the year. Frank becomes eligible for the plan on July 1 of the current plan year. The plan year ends December 31. Frank does not start making elective contributions until October 1 of that year. His deferral election for the fourth quarter of the year is 10 percent of compensation.

Plan Year Quarter	Compensation	Elective Contribution Amount
January 1 - March 31	$10,000	$0 (not eligible)
April 1 - June 30	$10,000	$0 (not eligible)
July 1 - September 30	$10,000	$0 (eligible but not deferring)
October 1 - December 31	$10,000	$1,000 (10% deferral rate)
Totals	$40,000	$1,000 (2.5% of year's pay)

There are three possibilities for calculating the 4 percent limit on the match. One approach is to count compensation for the entire year (January 1 through December 31 in this example), regardless of whether Frank is eligible. Under this approach, the cap on the

match would be 4% x $40,000, or $1,600. Because Frank's elective contributions total only $1,000, the match would be $1,000 (i.e., 100 percent of his entire elective contribution) and the cap would not affect the amount of the match.

A second approach is to count compensation for just the part of the year during which Frank is eligible to defer under the 401(k) plan, but including periods of eligibility when he is not actually deferring (July 1 through December 31 in this example). Under this approach, the cap on the match would be 4% x $20,000, or $800. Because Frank's elective contributions total $1,000, the match would be capped at $800 (i.e., 80 percent of his entire elective contribution).

A third approach is to count compensation for only the part of the year during which Frank is actually deferring (October 1 through December 31 in this example). Under this approach, the cap on the match would be 4% x $10,000, or $400. Because Frank's elective contributions total $1,000, the match would be capped at $400 (i.e., 40 percent of his entire elective contribution).

EXAMPLE 1-29. Effect of Changes in the Elective Contribution Rate on Amount of Match. A change in the employee's elective contribution rate during the plan year might affect the amount of match, depending on how the compensation period is measured. Suppose Jan is eligible for the entire plan year, but her deferral rate is lower for the second half of the year than the first half of the year.

Jan's compensation is $10,000 per quarter.

The plan provides an employer matching contribution of 50 percent on the first 6 percent deferred. Let's consider two approaches that might be taken by a plan to calculate the match in this example. One approach is to apply the formula on a plan year basis, using the participant's compensation ($40,000) and elective contributions for the entire year to calculate the match. A second approach is to apply the formula on a pay-as-you-go basis, where each quarter's match is based only on the compensation and the elective contributions for that period.

Plan Year Quarter	Compensation	Elective Contribution Amount
January 1 - March 31	$10,000	$800 (8% deferral rate)
April 1 - June 30	$10,000	$800 (8% deferral rate)
July 1 - September 30	$10,000	$300 (change to 3% deferral rate)
October 1 - December 31	$10,000	$300 (3% deferral rate)
Totals	$40,000	$2,200 (5.5% of year's pay)

Approach #1: cap determined based on compensation paid for the plan year. In this case, the 6 percent cap on elective contributions is based on Jan's compensation for the entire year and all elective contributions for the year are taken into account to determine the percentage of compensation deferred. In this example, Jan's compensation for the year is $40,000, so the first 6 percent of elective contributions is $2,400. The total of the elective contributions for the year is $2,200, which is less than 6 percent of the plan year

compensation. Therefore, the entire amount is matched at the plan's matching rate of 50 percent. Jan's match is $1,100 (i.e., 50% x $2,200).

Under this approach, anyone who defers less than 6 percent of compensation paid during the year will receive a full employer matching contribution on the elective contributions, regardless of the pattern of contributions during the year. A participant who defers 6 percent of each paycheck will get the same employer matching contribution rate as someone who defers nothing during the year and then defers an amount equal to 6 percent of his or her plan year compensation out of an end-of-year bonus.

Approach #2: cap determined based on compensation paid during the period for which the match is being made. If the plan determines the match for each quarter separately, Jan's match would be less than $1,100. Under this approach, only the compensation and elective contributions for each quarter are taken into account to calculate the percentage of compensation deferred and the 50 percent employer matching contribution liability. For the first two quarters of the year, the first 6 percent deferred is $600 per quarter, which is matched at $300. The other $200 of deferral per quarter is not matched. For each of the last two quarters, the $300 deferred in that quarter is less than 6 percent of compensation, so the match is 50 percent of the entire amount of elective contributions, or $150. The sum of the employer matching contributions for the four quarters is: $300 + $300 + $150 + $150, or $900. Jan's match is $200 less under this approach than under the first approach.

Under this type of approach, the only way for a participant who defers a total of 6 percent of his or her compensation during the year to get the maximum match is if the elective contributions are spread evenly over the entire year. A person who defers less than the 6 percent level in a given quarter will not receive the maximum matching for the year even if he or she defers more than the 6 percent level in other quarter.

If an employer matching contribution is funded during the year, but the cap on the match is based on the entire year's compensation (or for a period that is longer than the portion of the year in which the employee was actually deferring), it may be necessary for the employer to true-up the matching contribution after the close of the plan year (i.e., make up the difference between the match already funded and the employer matching contribution to which the participant is entitled under the formula). This happens if the employer funds the match during the year, using compensation paid through the date of the contribution to calculate the amount of match to deposit. Subsequent compensation payments for the measuring period might result in a liability for additional employer matching contributions on the elective contributions made in the earlier payroll periods.

Calculating employer matching contributions on the basis of compensation for the entire year also will enable an employee to realize a greater match where certain limits, such as the IRC §401(a)(30) limit, precludes him or her from deferring for the entire plan year.

EXAMPLE 1-30. Elective Contributions Stopped Because of IRC §401(a)(30) Limit. A 401(k) plan matches elective contributions, $1-for-$1 (i.e., 100 percent), but only up to 6 percent of compensation. Gina earns $180,000 ($45,000 per quarter). Gina elects to defer 20 percent of compensation.

For the calendar year 2019, the plan deducts 20 percent of Gina's compensation from her paycheck during the period from January 1 through June 30. At that point, the plan, as required by IRC §401(a)(30), suspends Gina's elective contributions because she has reached the dollar limit under IRC §402(g) dollar limit for that year ($18,500). (Gina is not catch-up eligible.) Elective contributions resume as of January 1 of the following year. The plan year ends December 31.

Plan Year Quarter	Compensation	Elective Contribution Amount
January 1 - March 31	$45,000	$9,000 (20% deferral rate)
April 1 - June 30	$45,000	$9,000 (20% deferral rate)
July 1 - September 30	$45,000	$1,000 (IRC §401(a)(30) limit applies)
October 1 - December 31	$45,000	$0 (IRC §401(a)(30) limit applies)
Totals	$180,000	$19,000 (10% of year's pay)

If the plan calculates matching contributions on a quarterly basis, Gina's match is only $5,900, which is 6% x $90,000 (i.e., 6 percent of compensation for the first two quarters and $1,000 for the third quarter, which is the period during which the employee was actually deferring). On the other hand, if the plan determines the employer matching contribution on the basis of the compensation for the full plan year, the match is capped at 6% x $180,000, or $10,800.

DISCRETIONARY MATCHING CONTRIBUTIONS

Sometimes the employer does not want to commit to making a certain level of matching contribution, but wants the flexibility of determining on an annual basis what the rate of match should be on the participants' elective contributions. In that situation, the plan may permit the employer to make a discretionary matching contribution. The discretionary matching contribution may be the only match in the plan, or the plan may provide a certain set formula for employer matching contributions, but provide the employer with an option to make an additional match if it wants to do so.

EXAMPLE 1-31. Discretionary Match. A plan provides for a discretionary matching contribution. The employer decides for the current year that the rate of match should be 40 percent of elective contributions. The elective contributions made by all participants total $90,000. The employer contributes a total of 40 percent of that amount, or $36,000, as its discretionary matching contribution.

Marisa's elective contributions for the year equal $5,000. Marisa's share of the employer matching contribution is 40 percent of $5,000, or $2,000. The allocation formula would require the administrator to allocate $2,000 of the employer's discretionary matching contribution to Marisa's account to reflect her share of employer matching contributions.

Suppose the employer wants the discretion to determine the rate of match, but also wants to be able to cap the match at a percentage of compensation or at a dollar amount. The cap is usually

predetermined in the document. For example, the plan might provide that the rate of match is determined at the employer's discretion, but the total match allocable to a participant cannot exceed a specified percentage (e.g., 3 percent) of the participant's compensation for the plan year. Some plans will give the employer the discretion to set the cap on the match, as well as the discretion to set the rate of the match. For example, the plan may provide that the employer will match the participants' elective contributions at a rate determined by the employer, and the amount of match allocated to a participant for any plan year is limited to a percentage of compensation (uniformly applied to all participants) that is also determined at the employer's discretion.

There is some concern that this type of formula may provide too much discretion. In other words, the plan could be considered to fail to satisfy the requirement to have a definite allocation formula under Treas. Reg. §1.401-1(b)(1)(ii). If the plan expressly provides this type of discretion, the determination letter issued on the plan (or, if the plan is a pre-approved document, that preapproval) should provide reliance on this issue and protect the plan from disqualification. Some plans provide that the rate of match on a tiered formula is determined at the employer's discretion from year to year.

Matching Catch-up Contributions

The plan may choose whether to provide employer matching contributions on any catch-up contributions that are made to the plan. The employer matching contribution formula that applies to the catch-up contributions may be the same formula that applies to regular elective contributions (i.e., catch-up contributions are treated like any other elective contributions and the matching formula is applied accordingly), or it may be a different formula. However, if a separate formula applies, special testing under IRC §401(a)(4) may be necessary to determine if those employer matching contributions are available on a nondiscriminatory basis.[82]

Employer matching contributions on catch-up contributions are subject to all of the applicable limits and nondiscrimination tests as other employer matching contributions. Thus, employer matching contributions made on catch-up contributions are subject to the IRC §415 limits, even though the catch-up contributions are not.

Furthermore, employer matching contributions made on catch-up contributions are subject to the ACP nondiscrimination test under IRC §401(m), even though the catch-up contributions are not subject to the ADP test under IRC §401(k).

If the plan's employer matching contribution formula does not specifically exclude catch-up contributions, then a participant's catch-up contributions will be treated like any other elective contributions to determine if an employer matching contribution is due.

Except for the more generous matching formulas, the level of contributions that are eligible for a match is usually below the level at which elective contributions would be treated as catch-up contributions, anyway. Employer matching contribution formulas commonly limit the level of elective contributions (usually as a percentage of compensation) that is eligible for an employer matching contribution. In most cases, this percentage cap would effectively exclude catch-up contributions. For example, suppose a 401(k) plan provides for a 100 percent match on the first 4

[82] Treas. Reg. §1.414(v)-1(d)(4).

percent of compensation deferred. Even an employee who earns the maximum includible compensation of $285,000 (for 2020) would have only the first $11,400 of elective contributions (i.e., 4% x $285,000) eligible for the match, which is still less than the IRC §402(g) dollar limit. Therefore, when there is a limit on the amount of elective contributions that are matched, the failure to match catch-up contributions will likely apply only to highly-paid HCEs, if at all.

EXAMPLE 1-32. Matching Catch-up Contributions. An employee's compensation is $250,000 for 2020. The employee is catch-up eligible and defers $26,000 for 2020 (i.e., the sum of the IRC §402(g) dollar limit of $19,500 and the catch-up limit of $65000). The plan's matching formula applies to the first 8 percent of elective contributions.

The match will apply to $20,000 of this employee's elective contributions (i.e., 8% x $250,000). However, if the plan does not match catch-up contributions, only $19,500 (i.e., the §402(g) limit) will be eligible for a matching contribution; the remaining $500 of the employee's elective contributions that are reclassified as catch-up contributions will not be matched.

If the employer does not want to match catch-up contributions that are a result of the IRC §402(g) dollar limit, it might consider writing into the formula that the match applies to the lesser of the first 8 percent of elective contributions or the maximum dollar amount permitted under IRC §402(g) without regard to the catch-up limit. This would not result in a discriminatory availability with respect to the rate of match, because the cap on elective contributions would be applied uniformly to all eligible participants.

If a 401(k) plan has a plan-imposed limit, usually the lesser-compensated employees will be affected more than the higher-compensated employees with respect to the determination of catch-up contributions.

EXAMPLE 1-33. Plan-Imposed Limit. A 401(k) plan has a 15 percent limit on elective contributions, but the matching contribution formula simply states that all elective contributions are matched at a rate of 25 percent. The plan year ends December 31. For the 2020 plan year, a catch-up eligible employee who earns $50,000 per year defers the plan-imposed limit (i.e., 15 percent of compensation, or $7,500) plus $6,500 (i.e., the 2020 catch-up limit), for a total elective contribution for the plan year of $14,000. The 25 percent match would apply to the entire $14,000 because the matching formula applies to all elective contributions, resulting in a match of $3,500 (i.e., 25% x $14,000).

If the employer in the previous EXAMPLE 1-33 did not want to match the catch-up contributions, how might it redesign the plan's matching formula? One approach would be to provide that the 25 percent match applies only to the first 15 percent of elective contributions. This way, only the first $7,500 of the employee's elective contributions would be matched and the catch-up contributions

would not be matched. An alternative approach is to specify that catch-up contributions are not eligible for match.

The fact that a failure to match catch-up contributions usually affects primarily HCEs is even better illustrated when the reason for the reclassification of elective contributions to catch-up contributions is the failure of the ADP test. If a 401(k) plan that allows catch-up contributions fails its ADP test, the excess contributions made by a catch-up eligible HCE must be recharacterized as catch-up contributions (to the extent of the catch-up limit not already used up by the HCE before the ADP test is performed).[83] If the plan does not match catch-up contributions, the elective contributions that are reclassified will no longer be eligible to receive an employer matching contribution.

EXAMPLE 1-34. ADP Test Failure. James, a catch-up eligible HCE, has compensation equal to $195,000 for the 2020 calendar plan year. James defers the maximum $19,500 for the year. The plan matches elective contributions up to 10 percent of compensation, but does not match catch-up contributions. [Note that the effect of this provision is that no one who has compensation below $195,000 will have catch-up contributions subject to a match, because they will not have reached the IRC §402(g) deferral limit at 10 percent of compensation]. Because the $19,500 elective contribution is equal to 10 percent of James' compensation, .it would customarily be eligible for matching contributions.

After the ADP test is run, James' maximum elective deferral is limited to $13,000 and $5,500 is recharacterized as a catch-up contribution. Although James would customarily be eligible to have his entire elective contribution matched, the recharacterization of $6,500 of the elective contribution to be a catch-up contribution would deny him an employer matching contribution on that portion of his elective contributions. Therefore, only 6.67 percent of his compensation is subject to employer matching contributions, while the NHCEs are eligible to receive employer matching contributions on up to 10 percent of compensation.

Therefore, the decision not to match catch-up contributions primarily and significantly affects only the HCEs whose elective deferrals are reclassified due to the ADP testing failure.

Matching Other Contributions

If a 401(k) plan also permits after-tax employee contributions, the matching contribution formula might apply to only the elective contributions, only the after-tax employee contributions or to both

[83] Treas. Reg. §1.414(v)-1(d)(2)(iii).

types of contributions. The plan document will need to specify which contributions are eligible for employer matching contributions.

Limits on Matching Contributions

Two legal limits may reduce the amount of employer matching contributions that a participant may receive. First, employer matching contributions are annual additions under IRC §415. When added to the other annual additions— elective contributions, after-tax employee contributions, employer nonelective contributions (discussed below) and forfeiture allocations, the employer matching contributions cannot exceed the lesser of 100 percent of compensation or $57,000 (in 2020, subject to cost-of-living increases thereafter).

Second, employer matching contributions and after-tax employee contributions are subject to nondiscrimination testing under IRC §401(m) (ACP testing). If this test is fails, some of the employer matching contribution allocated to the accounts of HCEs may need to be distributed or forfeited so that the testing is passed.

1.08: Nonelective Contributions

Because a 401(k) plan must be designated as a profit-sharing plan or as a stock bonus plan, the employer may design the plan to include an employer contribution other than an employer matching contribution. The employer contribution made under this formula is called a nonelective contribution (or profit-sharing contribution), because it is made by the employer without regard to whether an election to defer has been made by the employee. The nonelective designation distinguishes the contribution from the elective contributions, which are contributed by the employer directly at the employees' elections, and from the employer matching contributions, which are contributed by the employer indirectly at the employees' elections because they are made only on behalf of the participants who have made elective contributions. The nonelective contribution designation applies, whether the amount of this contribution is determined at the employer's discretion or is specified in the plan document.

If the plan provides for a nonelective contribution, the plan will define the contribution formula used by the employer to determine the amount of the nonelective contributions only. This formula will be in addition to the contribution formula relating to the elective contributions (i.e., the 401(k) portion of the plan), which authorizes the employer to contribute to the plan the amount that represents the elective contributions elected by the eligible participants. The nonelective formula will also be in addition to the contribution formula relating to the matching contributions. The amount of the nonelective contribution is usually determined under a discretionary formula.

The plan will also define the allocation formula, which will determine how the contributions described in the contribution formula will be allocated among the participants’ accounts.

The employer is not required to include a nonelective contribution formula in a 401(k) plan. The plan may provide that the only contributions made to the plan are elective contributions under the 401(k) arrangement, or that the only contributions made to the plan are elective contributions and matching contributions. A plan that provides for only elective contributions, or only for elective

contributions and matching contributions, and no other employer contributions, is still treated as a profit-sharing plan or stock bonus plan, depending on its stated designation.

Employer nonelective contributions are annual additions under IRC §415, and may be restricted to a given percentage of pay or dollar amount to help avoid exceeding this limit.

1.09: IRC §401(k) Distribution Restrictions

Elective contributions in a 401(k) plan are subject to distribution restrictions.[84] These restrictions apply, even though the 401(k) arrangement is part of a profit-sharing or stock bonus plan with other contributions that are subject to more liberal distribution rules.

Distributions of elective contributions from a 401(k) plan may be permitted upon occurrence of any of the following events:

- The employee's severance from employment,
- The employee's death,
- The employee's disability,
- The employee's attainment of age 59½ (or a later specified age), even if the employee has not had a severance from employment,
- The employee's financial hardship, even if the employee has not had a severance from employment,
- The termination of the plan, even if the employee has not had a severance from employment, but only if the employer does not maintain an alternate defined contribution plan,
- Permissible withdrawal under an EACA (post-2007),
- Certain military service by qualified reservists, or
- Qualified hurricane distribution.

The 401(k) plan does not need to permit distribution of elective contributions upon all of these events, but may be more restrictive. However, no distribution is permitted if none of these events has occurred.

SEVERANCE FROM EMPLOYMENT

A severance from employment means that the employee is no longer working for the employer that maintains the 401(k) plan, due to either a voluntary or involuntary termination of employment. If the employer is acquired in a business transaction, a severance from employment of the employee also might occur, even though the employee continues to work in the same job capacity

[84] IRC §401(k)(2) and (10).

for the acquiring employer.[85] However, some acquisitions do not cause a severance from employment, and in those circumstances, another type of distribution event must justify the payout.

Treasury regulations help clarify when a severance from employment occurs in a business transaction.[86]

HARDSHIP WITHDRAWALS OF ELECTIVE CONTRIBUTIONS

The 401(k) regulations outline rules for determining when an employee's elective contributions may be withdrawn because of a financial hardship. A 401(k) plan is not required to permit hardship withdrawals of elective contributions, even if it permits hardship withdrawals of profit-sharing nonelective contributions. However, if hardship distributions are permitted for elective contributions and other types of contributions, the 401(k) distribution rules apply only to the elective contributions.

AUTOMATIC ENROLLMENT DEFERRALS

An EACA may allow employees to elect to withdraw their elective contributions that have been made as a result of the automatic enrollment feature. A permissible withdrawal is a distribution made at the employee's election of all contributions made by the automatic enrollment on behalf of the employee. Permissible withdrawals may be requested only in the first 90 days of an individual's participation in an automatic contribution arrangement. This rule is effective for plan years beginning in 2008 or later.

QNECS, QMACS AND SAFE HARBOR 401(K) CONTRIBUTIONS SIMILARLY RESTRICTED

The distribution restrictions that apply to elective contributions in a 401(k) plan also apply to qualified nonelective contributions (QNECs), qualified matching contributions (QMACs) and safe harbor 401(k) contributions, with one significant difference. While elective contributions may be distributed on account of hardship, this was not permissible for QNECs, QMACs or safe harbor 401(k) contributions prior to the 2019 plan year. (QNECs and QMACs are special employer contributions that may be used to help the plan pass ADP or ACP testing.) Effective with the 2019 plan year, the plan has the option to allow these sources to be distributed on account of hardship.

Matching contributions and nonelective contributions (that are not QNECs, QMACs or safe harbor 401(k) contributions) are subject to the normal distribution rules that apply to profit-sharing plans and stock bonus plans. For example, the employer's nonelective contributions could be available for distribution after five years of participation in the plan, or attainment of a specified age that is

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[85] IRC §401(k)(2)(B)(i)(I); Treas. Reg. §1.401(k)-1(d)(2).
[86] Treas. Reg. §1.401(k)-1(d)(2).

younger than age 59½, even though the elective contributions could not be distributable at such time.

If You're Curious …

Transferred Accounts

Except in the case of an elective transfer of distributable benefits or a direct rollover, the distribution restrictions on elective contributions continue even if these amounts are transferred to another plan.[87] The transferee plan will fail to be qualified if the transferred amounts are not subject to these restrictions. Treasury regulations also require the transferor plan to refrain from transferring amounts to another plan that does not provide for a continuation of the restrictions.[88] The transferor plan is deemed to comply with this requirement if it reasonably concludes that the transferee plan provides for these distribution restrictions. The rules applicable to direct rollovers for reasonably concluding whether a recipient plan is qualified apply for this purpose.[89]

1.10: Review of Key Concepts

- What types of plans are permitted to have a 401(k) feature?
- What types of contributions may be found in a 401(k) plan?
- What is a salary reduction agreement?
- Explain automatic enrollment, including the differences between an automatic contribution arrangement, an EACA and a QACA.
- What are the limits on elective deferrals?
- How do IRC §§401(a)(30) and 402(g) interact?
- What is a plan's limit under IRC §401(a)(30)?
- What is an individual's limit under IRC §402(g)?
- Describe an excess deferral.
- How are excess deferrals determined and corrected?
- What are the tax consequences of an excess deferral?
- What are designated Roth contributions?
- What is a catch-up contribution?
- Describe how to determine if a participant is a catch-up eligible participant.
- List situations in which elective deferrals may be considered catch-up contributions.
- What are the special rules that apply to after-tax employee contributions?
- Describe the rules applicable to matching contributions.
- What are the special distribution restrictions applicable to 401(k) plans, specifically elective contributions?

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[87] Treas. Reg. §1.401(k)-1(d)(5)(iv).
[88] Treas. Reg. §1.401(k)-1(d)(5)(iv).
[89] Treas. Reg. §1.401(a)(31)-1, Q&A-14.

1.11: For Practice – True or False

1. A 401(k) plan may require two years of service for eligibility in the profit-sharing component of the plan.
2. A post-ERISA money purchase plan may allow for elective contributions.
3. Elective contributions may be eligible for hardship withdrawal.
4. Excess deferrals must be distributed from the plan within 2½ months after the plan year-end.
5. Catch-up contributions are included in the participant's annual addition limit under IRC §415.
6. An employer may elect to make matching contributions on catch-up contributions.
7. Designated Roth contributions are elective contributions that are made on an after-tax basis.
8. Elective contributions are available for distribution only after a participant completes two years of service.
9. Elective contributions may be recharacterized as catch-up contributions due to a failed ADP test.
10. A participant must be age 50 to make designated Roth contributions.
11. An EACA requires an annual notice to participants.

1.12: Sample Test Questions

1. A 401(k) plan must comply with all of the following requirements in order to obtain favorable tax treatment, EXCEPT:

   A. Participants must be given the option to elect to receive cash compensation or have the amounts contributed to the 401(k) plan as elective contributions.
   B. Elective contributions may not be distributed based on the passage of a fixed number of years of plan participation.
   C. Plan benefits, other than employer matching contributions, may not be dependent on the participant making elective deferrals.
   D. Elective contributions and earnings thereon must be 100 percent vested at all times.
   E. Participants must be given the right to direct the investments of their deferrals.

2. All of the following statements describe characteristics of 401(k) plans, EXCEPT:

   A. A stock bonus plan may include a 401(k) feature.
   B. Tax-exempt organizations may establish a 401(k) plan.
   C. A 401(k) plan may require up to two years of service for the elective contribution component of the plan.
   D. Elective contributions are subject to Social Security and Medicare taxes (FICA).
   E. Self-employed individuals may participate in a 401(k) plan.

3. All of the following statements regarding types of contributions in 401(k) plans are TRUE, EXCEPT:

   A. Nonelective contributions are made by the employer and are not related to a participant's elective contributions.
   B. Matching contributions are based on the amount of a participant's elective contributions.
   C. QMACs are 100 percent vested.
   D. A 401(k) plan must provide for either matching or nonelective contributions.
   E. QNECs are 100 percent vested.

4. Based on the following information, determine the participant's excess deferral for 2020:

   - The plan is a calendar year 401(k) plan.
   - The employer made no contributions to participants for 2020.
   - The participant did not make elective contributions into any other plan during the year.
   - The participant is age 30 and is an NHCE.
   - The IRC §402(g) dollar limit is $19,500 and the catch-up limit is $6,500.
   - The participant made pre-tax elective contributions of $19,500.
   - The participant made designated Roth contributions of $2,500.

   A. $0
   B. $1,000
   C. $1,500
   D. $2,500
   E. $4,500

5. Based on the following information, determine when the participant is catch-up eligible:

   - The 401(k) plan is a calendar year plan.
   - The participant's date of birth is March 15, 1969.

   A. December 31, 2017
   B. January 1, 2019
   C. March 15, 2019
   D. July 1, 2019
   E. March 15, 2020

6. All of the following statements regarding excess deferrals are TRUE, EXCEPT:

   A. Excess deferrals that are not timely distributed may cause plan disqualification.
   B. Earnings distributed on excess deferrals are taxable in the year of distribution.
   C. Excess deferrals are determined with respect to the calendar year.
   D. Excess deferrals that are timely distributed are taxable in the year of deferral.
   E. Excess deferrals that are not timely distributed are subject to a 10 percent excise tax.

7. Which of the following statements regarding 401(k) plan distributions is/are TRUE?

    I. Elective deferrals may be distributed after attainment of age 59½ even if the participant is still employed.
    II. QNECs and QMACs may be distributed on account of hardship effective in the 2019 plan year.
    III. A 401(k) plan must permit hardship withdrawals of elective contributions.

    A. I only
    B. I and II only
    C. I and III only
    D. II and III only
    E. I, II and III

8. Which of the following statements regarding designated Roth contributions is/are TRUE?

    I. Designated Roth contributions are elective deferrals made on an after tax basis.
    II. Designated Roth contributions are tested for nondiscrimination purposes in the ACP test.
    III. The IRC §402(g) limit on elective deferrals applies to designated Roth contributions.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

9. Which of the following statements regarding EACAs and QACAs is/are TRUE?

    I. A QACA is an ACA that satisfies 401(k) safe harbor plan requirements.
    II. During the first 120 days of participation in an EACA, employees may withdraw elective contributions made as a result of automatic enrollment.
    III. An EACA with no nonelective contributions may qualify for an exemption from top-heavy rules.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. Which of the following statements regarding 401(k) plan distributions is/are TRUE?

    I. Elective contributions may be distributed after attainment of age 50½ even if the participant is still employed.
    II. Safe harbor 401(k) matching and nonelective contributions may not be distributed on account of hardship prior to the 2019 plan year.
    III. All employer matching contributions in a 401(k) plan are subject to the same distribution restrictions as the elective contributions.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

1.13: Solutions to True or False Questions

1. True.
2. False. Elective contributions are permitted in profit-sharing, stock bonus and pre-ERISA money purchase plans.
3. True.
4. False. Excess deferrals occur when an individual exceeds the IRC §402(g) dollar limit. This limit is determined each calendar year (tax year of the individual) and is not affected by the plan year. Excess deferrals should be refunded no later than April 15 following the year of excess.
5. False. Catch-up contributions are not included in determining whether a participant has exceeded the annual addition limit under IRC §415.
6. True.
7. True.
8. False. Elective contributions are only available for distribution under certain circumstances, including severance from employment, death, disability, attainment of age 59½, financial hardship, plan termination, eligible automatic contribution arrangement, certain military service and qualified hurricane distributions.
9. True.
10. False. Designated Roth contributions are elective contributions made on an after tax basis and may be made by any eligible participant, regardless of the participant's age. A participant must be age 50 to be catch-up eligible.
11. True.

1.14: Solutions to Sample Test Questions

1. The answer is **E**. Although it is very common to allow participants to direct the investment of their elective contributions, it is not a requirement of a qualified plan.
2. The answer is **C**. The 401(k) component may require no more than one year of service for eligibility purposes.
3. The answer is **D**. It is common for a 401(k) plan to include a matching or a nonelective feature, but it is not a requirement.
4. The answer is **D**. The participant made total elective contributions of $22,000 ($19,500 + $2,500). The participant is not catch-up eligible (only age 30) so the IRC §402(g) dollar limit of $19,500 applies to this individual. The participant had excess deferrals of $2,500 ($22,000 - $19,500).
5. The answer is **B**. The participant attains age 50 on March 15, 2019. The participant is catch-up eligible in the plan year (January 1, 2019 – December 31, 2019) during which the participant attains age 50.
6. The answer is **E**. There is no excise tax associated with excess deferrals and their timely distribution.
7. The answer is **B**. QNECs and QMACs and safe harbor 401(k) contributions may be distributed on account of hardship effective with the 2019 plan year. A 401(k) plan may permit hardship withdrawals of elective contributions, but is not required to do so.

8. The answer is **C**. Designated Roth contributions are tested for nondiscrimination purposes in the ADP test.
9. The answer is **A**. During the first 90 days of participation in an EACA, employees may withdraw elective contributions made as a result of automatic enrollment. A QACA with no nonelective contributions may qualify for an exemption from top-heavy rules. This exemption is not available to EACAs.
10. The answer is **B**. Elective contributions may be distributed after attainment of age 59½ even if the participant is still employed, but not at age 50½. The distribution restrictions that apply to elective contributions do not apply to nonsafe harbor matching contributions.

CHAPTER 2:

401(K) COVERAGE AND NONDISCRIMINATION

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2.01: Key Terms

- 1.25 test
- 2 percent spread test
- Actual contribution percentage (ACP) test
- Actual contribution ratio (ACR)
- Actual deferral percentage (ADP) test
- Actual deferral ratio (ADR)
- Annual testing method
- Benefiting
- Current year testing method
- Dual eligibility
- Five-year rule
- Mandatory disaggregation
- Otherwise excludable employees
- Prior year testing method
- Statutory employees

2.02: Introduction

401(k) plans are subject to special coverage and nondiscrimination testing. These two requirements are probably the most complex elements of 401(k) plan administration.

The coverage rules under Internal Revenue Code (IRC) §410(b) are unique for 401(k) plans, because testing is required to be performed as if each contribution type (i.e., elective contributions, employer matching contributions and employer nonelective contributions) were a separate plan. Therefore, a 401(k) plan that contains all three types of contributions will actually be subject to three separate coverage tests each plan year. Separating each contribution type for testing purposes is referred to as disaggregation.

401(k) plans are also subject to nondiscrimination testing under IRC §401(a)(4). However, all the standard rules that normally apply under that IRC section for purposes of determining if benefit amounts are nondiscriminatory are overridden by the Actual Deferral Percentage (ADP) and Actual Contribution Percentage (ACP) tests for 401(k) plans. At first blush, these two tests appear simple, but that appearance is deceptive. In fact, the rules for this testing and the correction of failed testing are fairly intricate. An employer that wants to avoid this nondiscrimination testing has an alternative: the IRC provides certain safe harbors that will permit a plan sponsor to bypass the ADP and ACP tests entirely. This chapter will discuss the ins and outs of coverage and nondiscrimination tests that are unique to 401(k) plans.

2.03: Coverage Testing

Coverage testing assesses whether plan participation is made available to a sufficient percentage of rank-and-file employees to be considered broad-based. Normally, coverage testing looks at who is benefiting, which generally includes only those individuals who receive a contribution or forfeiture allocation in a defined contribution plan. In a 401(k) plan, the coverage rules are adjusted to recognize that whether someone benefits under the plan is often in the participant's own hands. Therefore, the issue for coverage is not necessarily whether a participant takes advantage of an elective contribution feature, but whether the opportunity to do so is provided. Similarly, the issue is not whether a person actually receives an employer matching contribution, but whether the participant would be allocated a match if elective contributions are made.

Because coverage looks at the ratio of benefiting employees to total employees, it is critical to know who is the employer for this purpose and what plan is being examined. This is also discussed below.

Disaggregation

The employer is required to test coverage for the 401(k) arrangement (i.e., elective contributions) separately from the test for coverage for the 401(m) arrangement (i.e., matching and after-tax employee contributions).[1] This is often referred to as mandatory disaggregation and means that each disaggregated portion of the plan is treated as if it were a separate plan for purposes of testing coverage. A plan that includes a 401(k) arrangement may consist of up to three "plans" for coverage testing:

- the 401(k) plan;
- the 401(m) plan; and
- the 401(a) plan (i.e., the non-401(k)/non-401(m) plan).

The non-401(k)/non-401(m) part of the plan is the part of the plan representing employer nonelective contributions to the profit-sharing plan or stock bonus plan that contains the 401(k) arrangement and is sometimes referred to as the 401(a) portion of the plan. Any reference to 401(k) plan means the elective contribution portion of a plan and any reference to 401(m) plan means the matching and after-tax employee contribution portion of the plan.

Qualified matching contributions (QMACs) are permitted to be tested for nondiscrimination testing purposes under the ADP test, along with the elective deferrals, rather than being tested under the ACP test [which is the nondiscrimination test for matching and after-tax employee contributions, as required by IRC §401(m)].[2] However, for coverage testing purposes, QMACs are always part of the 401(m) plan, regardless of whether they are included in the ADP test or the ACP test.[3]

Elective deferrals may be included in the ACP test under certain circumstances.[4] Similar to the rule for QMACs described above, elective deferrals are always part of the 401(k) plan for coverage testing purposes, even if they are included in the ACP test for nondiscrimination testing purposes.[5]

Certain employer contributions, known as qualified nonelective contributions (QNECs), may be used in the ADP test.[6] QNECs may also be used in the ACP test. However, for coverage testing purposes, QNECs are not part of either the 401(k) plan or the 401(m) plan. Instead, QNECs are part of the 401(a) nonelective contribution portion of the plan, along with any other employer nonelective contributions allocated for the plan year, regardless of whether the QNECs are included in the ADP test or ACP test.[7]

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[1] Treas. Reg. §1.410(b)-7(c)(1).
[2] Treas. Reg. §1.401(k)-2(a)(6).
[3] Treas. Reg. §1.410(b)-9 (definition of section 401(m) plan).
[4] Treas. Reg. §1.401(m)-2(a)(6).
[5] Treas. Reg. §1.410(b)-9 (definition of section 401(k) plan).
[6] Treas. Reg. §1.401(k)-2(a)(6), Treas. Reg. §1.401(m)-2(a)(6).
[7] Treas. Reg. §1.410(b)-9 (definitions of section 401(k) plan and section 401(m) plan).

Safe Harbor 401(k) Plans

There is no special exception from coverage testing merely because a 401(k) plan is a safe harbor plan. This is true whether the plan is 401(k)(12) safe harbor plan (i.e., a "normal" 401(k) safe harbor plan) or a 401(k)(13) safe harbor plan (i.e., a QACA safe harbor plan). Safe harbor 401(k) plans are discussed in depth in chapter five.

The safe harbor rules only excuse the 401(k) arrangement from the ADP test, not from the coverage test. The plan still must cover a group of employees that can satisfy one of the coverage tests under IRC §410(b). For coverage purposes, the disaggregated 401(k) plan consists solely of the elective contributions, and does not include the safe harbor matching contributions or the safe harbor nonelective contributions made by the employer. The disaggregated 401(m) plan consists solely of the employer matching contributions (and after-tax employee contributions, if any), regardless of whether the employer matching contributions are safe harbor matching contributions, and regardless of whether the employer matching contributions satisfy the ACP safe harbor. The disaggregated non-401(k)/non-401(m) portion of the plan includes all nonelective contributions made by the employer regardless of whether the nonelective contributions (or a portion thereof) are safe harbor nonelective contributions.

Summary

Below is a summary of where each type of contribution is tested for IRC §410(b) coverage purposes under the mandatory disaggregation rules:

	Test Under 401(k) Portion?	Test Under 401(m) Portion?	Test Under 401(a) Portion?
Pre-tax elective deferrals	☑		
Designated Roth contributions	☑		
After-tax employee contributions		☑	
Nonsafe harbor matching contributions		☑	
Safe harbor matching contributions		☑	
QMACs		☑	
Employer nonelective contributions			☑
QNECs			☑
Safe harbor nonelective contributions			☑

TESTING THE DISAGGREGATED PARTS OF THE PLAN

The coverage testing group is separately determined for each disaggregated portion of the plan, based on who is an includable employee with respect to that plan—that is, the age and service conditions applicable to the disaggregated portion of the plan are applied to the employee census for this purpose. The benefiting group includes only the employees who benefit under the disaggregated portion of the plan being tested. For example, when testing the 401(k) plan, only the employees who are benefiting under the 401(k) arrangement are included in the benefiting group.

A 401(k) arrangement and a 401(m) arrangement must be tested on the annual testing method.[8] That means the coverage testing group must be determined by taking into account the workforce during the entire plan year (unless the snapshot testing date is used, as permitted under Rev. Proc. 93-42).

If You're Curious . .

Rev. Proc. 93-42 allows an employer to demonstrate compliance with non-discrimination rules, including 410(b) minimum coverage testing, on the basis of the employer's workforce on a single day during a plan year. The single day selected must be a reasonable representation of the employer's workforce throughout the plan year. Recognizing that the snapshot method may overstate participation in the plan due to contribution allocation requirements, adjustments to the 70 percent threshold are required when a snapshot testing date is used. If hours of service are required to receive contributions, the 70 percent threshold is adjusted by 5 percent (i.e., 73.5 percent is the required ratio percentage) when a snapshot testing date is used. If employment on the last day of the plan year is required to receive contributions, the 70 percent threshold is adjusted by 10 percent (i.e., 77 percent is the required ratio percentage) when a snapshot testing date is used.

Ratio Percentage Test

The ratio percentage test is performed separately for each disaggregated plan based on the benefiting group identified for that plan.

Determining the Coverage Testing Group and the Benefiting Group Under a 401(k) Plan

There are special rules for determining who is to be tested for coverage and who is considered to be benefiting under a 401(k) plan.

Coverage Testing Group for 401(k)

When determining the coverage testing group for the 401(k) plan, the exclusion category for terminated participants who complete 500 or fewer hours during the plan year does not apply. These participants are not excludable employees when testing the 401(k) plan because termination during the year, or the failure to complete a given number of hours during the year, does not affect whether the employee is eligible to make elective contributions. Someone who previously completed the eligibility requirements to be in the 401(k) plan will be able to make elective contributions for the part of the plan year during which the participant was employed.

EXAMPLE 2-1. Terminated Not Excludable. Bernard is a participant in a 401(k) plan. During the current plan year, he terminated employment after

[8] Treas. Reg. §1.410(b)-8(a)(1).

completing only 200 hours of service for the plan year. Bernard is not an excludable employee for purposes of determining the coverage testing group for the 401(k) plan.

Benefiting Group for 401(k) Plan

Normally a participant is benefiting under a defined contribution plan only if allocated employer contributions or forfeitures. In a defined contribution plan with a 401(k) feature, any employee that is eligible for the 401(k) portion of the plan is considered to be benefiting.[9] An eligible employee is an employee who is permitted to make elective contributions at any time during the plan year, regardless of whether such contributions are made and regardless of whether employment is terminated during the plan year.[10] The participant is treated as benefiting even if the right to defer is suspended because of a distribution (e.g., hardship), loan or election not to participate.

EXAMPLE 2-2. Election Not to Defer. Art commences employment on May 1, 2019. He is eligible to participate in his employer's 401(k) plan on the semiannual entry date following completion of one year of service. The plan year is the calendar year. Art becomes eligible on July 1, 2020, but chooses not to make elective contributions until January 1, 2021. Art is an eligible employee for the 2020 plan year, because he is eligible to participate in the 401(k) arrangement during the last six months of that plan year. When testing the disaggregated 401(k) plan for coverage in the 2020 plan year, the plan includes Art in the benefiting group.

The result is different if an employee is permitted to make a one-time irrevocable election to never participate in the 401(k) plan at the time he or she is first employed or eligible to participate. This type of employee is included in the coverage testing group, but is not considered to be an eligible employee who benefits under the plan.[11] (This is one reason why permitting irrevocable elections not to participant is problematic – it can cause a plan to fail coverage testing.) Such an employee is not considered to be an eligible employee for nondiscrimination testing purposes (i.e., the ADP test), as well. Irrevocable elections not to participant will be discussed in more detail later in this chapter.

[9] Treas. Reg. §1.410(b)-3(a)(2)(i).
[10] Treas. Reg. §1.401(k)-6 (definition of eligible employee).
[11] Treas. Reg. §1.401(k)-1(g)(4)(ii).

Determining the Coverage Testing Group and Benefiting Group Under a 401(m) Plan

Similar to the coverage rules for 401(k) plans, there are some special ways to determine the coverage testing group and the benefiting group for 401(m) plans.

Coverage Testing Group for 401(m) Plan

When determining the coverage testing group for the 401(m) plan, the exclusion for terminated participants who complete 500 or fewer hours of service during the plan year applies only if:

- the 401(m) plan consists only of employer matching contributions (i.e., there are no after-tax employee contributions); and
- an hours of service and/or last-day employment condition applies to an allocation of employer matching contributions.

EXAMPLE 2-3. Eligible Employee Terminates With 500 or Fewer Hours. Let us return to Bernard in **EXAMPLE 2-1.** Suppose the plan provides for employer matching contributions on the first 3 percent of compensation deferred under the 401(k) plan. Employer matching contributions are allocated only to participants who complete at least 1,000 hours of service for the plan year. For coverage purposes, the employer matching contributions constitute a separately tested 401(m) plan. There are no after-tax employee contributions under the plan.

During the current plan year, Bernard terminated employment after completing only 200 hours of service for the plan year. Bernard is an excludable employee for purposes of determining the coverage testing group for the 401(m) plan, because the allocation requirements for employer matching contributions include a service requirement and Bernard terminated during the plan year with 500 or fewer hours. Compare this to the result in **EXAMPLE 2-1**, where Bernard is not an excludable employee under the 401(k) portion of the plan.

EXAMPLE 2-4. Eligible Employee Terminates With More Than 500 Hours. Suppose, in the prior EXAMPLE 2-3, that Bernard had 650 hours of service for the plan year. Now he is included in the 401(m) plan coverage testing group because he did not terminate with 500 or fewer hours. However, he will be considered as not benefiting.

EXAMPLE 2-5. 401(m) Plan Includes After-Tax Employee Contributions. Suppose, in EXAMPLE 2-3, that the plan includes after-tax employee contributions and all employees who are eligible for the plan may elect to make such contributions. Now the 401(m) plan consists of both after-tax employee

contributions and employer matching contributions. Therefore, the terminated participants' exclusion does not apply.

Even though there is a service condition for benefiting under the employer matching contribution feature, no service requirement applies to an eligible employee's right to make after-tax employee contributions. Therefore, Bernard is not an excludable employee under the 401(m) plan, just like he is not an excludable employee under the 401(k) plan, as shown earlier in EXAMPLE 2-1.

Benefiting Group for 401(m) Plan

When testing the 401(m) plan, the employee is benefiting if he or she is an eligible employee under the 401(m) plan.[12] The 401(m) plan might consist of only employer matching contributions, only after-tax employee contributions or a combination of both contributions, depending on which contributions are permitted under the plan.

An employee is an eligible employee under the 401(m) plan if he or she is permitted to make after-tax employee contributions (if after-tax employee contributions are permitted) or is eligible to receive an allocation of employer matching contributions.[13] A participant is treated as eligible to receive employer matching contributions even if he or she does not make the elective contributions required for a match, as long as he or she would receive the employer matching contribution had he or she made such elective contributions. These rules also apply to determine the eligible employees for nondiscrimination testing purposes (i.e., the ACP test).

EXAMPLE 2-6. All Employees Eligible to Defer are Eligible for a Match. A plan provides for a 50 percent match on elective contributions. There is no hours or service or last day requirement to receive the matching contribution in this example. Arlene is an eligible employee under the 401(k) plan. If she makes elective contributions for the plan year, she will receive an employer matching contribution. For coverage purposes, Arlene is an eligible employee in the 401(m) arrangement, even if she chooses not to make elective contributions and does not actually receive an allocation of employer matching contributions. When testing the disaggregated 401(m) plan for coverage, the plan includes Arlene in the benefiting group.

Allocation Requirements for Matching Contributions

Employer matching contributions might be subject to allocation requirements similar to those applied to other employer contributions. For example, the plan may require the participant to be employed on the last day of the plan year and/ or to complete at least 1,000 hours of service for the plan year to receive an employer matching contribution allocation. In that case, the participant

[12] Treas. Reg. §1.410(b)-3(a)(2)(i).
[13] Treas. Reg. §1.401(k)-6 (definition of eligible employee).

is not an eligible employee under the 401(m) plan if he or she leaves before the last day of the plan year or fails to complete at least 1,000 hours of service during the plan year.

EXAMPLE 2-7. Last-day Employment Requirement for Matching Contributions. Assume a plan requires employment on the last day of the plan year to receive an employer matching contribution allocation. Leah terminates employment during the plan year. She is eligible to make elective contributions under the 401(k) plan.

Even if Leah had made elective contributions for the plan year, she would not have received an employer matching contribution because she left before the end of the plan year. In that case, she is not included in the benefiting group when testing coverage for the disaggregated 401(m) plan, even though she is included in the benefiting group when testing coverage for the disaggregated 401(k) plan. Note that, if Leah has 500 or fewer hours of service for the plan year, she may be excluded completely from the coverage testing group for the 401(m) plan.

In the prior **EXAMPLE 2-7**, Leah is not benefiting under the 401(m) plan because she terminated before the end of the year, thus becoming ineligible to receive an employer matching contribution for the plan year. Consider, in comparison, **EXAMPLE 2-5**, where Bernard was not eligible for the employer matching contributions, because he failed to complete 1,000 hours of service for the plan year, but he was eligible to make after-tax employee contributions. Bernard is treated as benefiting under the 401(m) plan for the plan year because he is eligible to make after-tax employee contributions. This is true even if Bernard chose not to make after-tax employee contributions for the plan year.

If You're Curious …

Effect of Separate Allocation Conditions for Each Month or Quarter of Plan Year

Suppose a 401(m) plan consists solely of employer matching contributions that are allocated as of the end of each quarter of the plan year or at the end of each month of the plan year. Furthermore, suppose a participant must have at least a minimum number of hours (e.g., 250 hours of service during a quarter) to receive a match on elective contributions made for that allocation period. A participant is benefiting for purposes of the coverage test if he or she satisfies the minimum hours requirement for any – even if not all – of the allocation periods in the plan year. As previously noted, a 401(m) plan must test coverage under the annual testing method.[14] Therefore, the participant's failure to be eligible for a match for some of the allocation periods will not affect the participant's status as benefiting under the plan for the plan year being tested.

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[14] Treas. Reg. §1.410(b)-8(a)(1).

EXAMPLE 2-8. Separate Hours Requirement for Allocation Periods Within the Year. A 401(k) plan requires a participant to complete at least 250 hours of service during a quarter to be eligible for employer matching contributions for that quarter. A participant completes 150 hours in the first quarter, 225 hours in the second quarter, 175 hours in the third quarter and 300 hours in the fourth quarter. Thus, the participant is eligible for employer matching contributions only in the fourth quarter. When performing the coverage test for the 401(m) plan for that plan year, the participant is treated as benefiting for the plan year.

A participant who is eligible for employer matching contributions is benefiting under the 401(m) plan, even if other participants are eligible for a greater rate of employer matching contributions. For example, suppose a plan bases the rate of match on a participant's number of years of service. Only participants with ten or more years of service receive a 100 percent match on elective contributions. Participants with fewer than ten years of service receive a lesser rate of match, based on a formula specified in the plan. Participants who are eligible for the lesser rates of match are still treated as benefiting for coverage purposes. Note, however, that the availability of different rates of match is a nondiscrimination testing issue under IRC §401(a)(4). Rates of match are rights and features under the plan that must be available on a nondiscriminatory basis.[15] The nondiscriminatory availability of rights and features is tested separately from the plan's coverage.

ILLUSTRATION OF COVERAGE TEST FOR 401(K) PLAN

Ratio Percentage Test Satisfied

A profit-sharing plan includes a 401(k) arrangement, employer matching contributions under a 401(m) arrangement and employer nonelective contributions. The workforce consists of 30 employees: five HCEs and 25 NHCEs. All employees who have completed one year of service are eligible to participate on the next entry date (January 1 or July 1). The employer matching contribution is 50 percent of elective contributions. A participant must be employed on the last day of the plan year (December 31) to receive an allocation of nonelective contributions. The last-day employment rule does not apply to employer matching contributions. The coverage test is performed as follows:

(a) Workforce during the plan year			30
(b) Number of employees who do not satisfy age/service as of 1/1 or 7/1 entry dates			2
(c) Number of employees not included in (b) who terminated before year end with 500 or fewer hours of service credited:			2
	For 401(k) Plan	**For 401(m) Plan**	**For 401(a) Plan**
(d) Coverage testing group [a – b (– c for 401(a) plan)]	28	28	26

[15] See, Treas. Reg. §1.401(a)(4)-4.

(e) Number of employees in (d) who terminated before year end with more than 500 hours of service credited during the plan year	n/a	n/a	4
(f) Benefiting group [d – e]	28	28	22
(g) Number of HCEs in coverage testing group	5	5	5
(h) Number of NHCEs in coverage testing group [d – g]	23	23	21
(i) Number of HCEs in benefiting group	5	5	5
(j) Number of NHCEs in benefiting group [f – i]	23	23	17
(k) NHCE ratio [j/h]	100%	100%	80.95%
(l) HCE ratio [i/g]	100%	100%	100%
(m) Coverage ratio [k/l]	100%	100%	80.95%

The exclusion in line (c) above relating to terminated participants with 500 or fewer hours of service does not apply to the 401(k) or 401(m) portions of the plan because neither hours of service nor last-day employment is required for participants to be able to make elective contributions or to receive an allocation of employer matching contributions.

In computing each step of the ratio percentage test, coverage testing groups, benefiting groups, NHCE ratios and HCE ratios are computed separately for each disaggregated plan. Each disaggregated plan passes the ratio percentage test because all percentages in step (m) are at least equal to 70 percent.

Some observations:

- If there were different age/service eligibility requirements for the three disaggregated portions of the plan, the numbers in line (b) could be different for each portion.
- If there were a minimum hours condition and/or a last-day employment condition for employer matching contributions, the excludable employee category in line (c) would apply to the 401(m) plan as well as the 401(a) plan, which would reduce the coverage testing group number in line (d). In addition, the benefiting group in line (f) would be smaller for the 401(m) plan because employees listed in line (e) would not be included in line (f).

Use of Average Benefit Test

If any percentage in line (m) of the above table was less than 70 percent, the average benefit test would have to be satisfied to pass coverage unless the number of benefiting employees is increased to satisfy the ratio percentage test.[16]

SPECIAL TESTING RULES

Otherwise Excludable Employees

When determining the coverage testing group, the employees who have not satisfied the plan's age and service requirements are excluded. If the plan's age and service requirements are more liberal than the statutory requirements of age 21 or one year of service, the plan is covering employees it otherwise could exclude from the coverage testing group. For example, a plan with a six-month eligibility condition is covering employees that would have been excluded under a one year of service condition. These employees are known as otherwise excludable employees. Under a special testing rule, the employer may disaggregate the portion of the plan covering the otherwise excludable employees from the rest of the employees (the statutory employees).

The coverage testing is done separately for the two employee groups, as if they were in separate plans. This disaggregation rule is elective. The employer may choose to run coverage testing without disaggregating the statutory employees and otherwise excludable employees and perform a single coverage test that takes into consideration both groups of employees in determining the coverage testing group and the coverage testing results.

The Coverage Testing Group for the Disaggregated Plans

When testing the plan covering otherwise excludable employees, the statutory employees are excluded from the coverage testing group. Also, any employees who fail to meet the age and service requirements imposed on the otherwise excludable employees are excluded from the coverage testing group. For example, if the plan requires three months of ser vice for eligibility, any employee who has not satisfied the three months of service requirement for the plan year, as well as any employee who satisfies the statutory age and service requirements, is an excludable employee when determining the coverage testing group for the disaggregated plan that covers the otherwise excludable employees. When testing the plan covering the statutory employees, all employees who fail to meet the statutory age and service requirements are excluded from the

[16] Treas. Reg. §1.401(a)(4)-11(g).

coverage testing group, including the otherwise excludable employees who are eligible for the plan.[17]

Consistency from Year-to-Year Not Required

If an employer disaggregates otherwise excludable employees to run coverage testing for the plan year, it is not required to take the same approach in the next plan year. The decision to use otherwise excludable employee disaggregation is made on a year-by-year basis.

Note, however, that the decision to disaggregate one year and not to disaggregate the next year, or vice versa, could affect the application of the prior year testing method under the ADP test or ACP test if the disaggregation election (or decision not to disaggregate) is made with respect to a 401(k) arrangement or a 401(m) arrangement.

EXAMPLE 2-9. Disaggregation. A profit-sharing plan's eligibility conditions are age 21 and six months of service. A participant must be employed on the last day of the plan year to receive an allocation of nonelective contributions. Suppose the employer does not disaggregate otherwise excludable employees. The plan fails the ratio percentage test, based on the following facts:

(a)	Workforce during plan year	30
(b)	Number of employees who do not satisfy plan's age/service as of the January 1 or July 1 entry dates	2
(c)	Number of employees not included in (b) who terminate before year end with 500 or fewer hours of service credited	1
(d)	Coverage testing group [(a) − (b) − (c)]	27
(e)	Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	9
(f)	Benefiting group [(d) − (e)]	18
(g)	Number of employees in (d) who are HCEs	5
(h)	Number of employees in (d) who are NHCEs [(d) − (g)]	22
(i)	Number of employees in (f) who are HCEs	5
(j)	Number of employees in (f) who are NHCEs [(f) − (i)]	13
(k)	NHCE ratio [(j)/(h)]	59.09%
(l)	HCE ratio [(i)/(g)]	100.00%
(m)	Coverage ratio [(k)/(l)]	59.09%

Because the terminated participants in step (e) were all NHCEs, the plan failed the ratio percentage test.

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[17] Treas. Reg. §1.410(b)-6(b)(3).

Suppose most of those terminations were in the otherwise excludable employee group and all the HCEs satisfy the statutory one-year-of-service requirement. By disaggregating the otherwise excludable employees from the plan under this special test, the plan would pass coverage. Here is how the coverage test would look if otherwise excludable employees ("OEE" in table below) were disaggregated from statutory employees.

(a)	Workforce during plan year	30	
(b)	Excludable by reason of age/service		
	(1) Number of employees who do not satisfy plan's age/service as of the January 1 or July 1 entry dates	2	
	(2) Number of employees (other than those included in (a)) who would not be eligible for the plan as of the January 1 or July 1 entry dates if the service requirement were one year [this is the otherwise excludable employee (OEE)group]	9	
		Statutory	**OEEs**
(c)	Number of employees who terminate before year end with 500 or fewer hours of service credited	0	1
(d)	Coverage testing group	19	8
(e)	Number of employees in (d) who terminate before year end with more than 500 hours of service credited during plan year	4	5
(f)	Benefiting group [(d) − (e)]	15	3
(g)	Number of employees who are HCEs	5	0
(h)	Number of employees who are NHCEs	14	8
(i)	Number of HCEs in benefiting group	5	0
(j)	Number of NHCEs in benefiting group	10	3
(k)	NHCE ratio [(j)/(h)]	71.43%	37.50%
(l)	HCE ratio [(i)/(g)]	100.00%	0.00%
(m)	Coverage ratio [(k)/(l)]	71.43%	N/A

The coverage ratio for the otherwise excludable employees (step (m), second column) is not computed because the HCE ratio (step (l), second column) is zero percent. When no HCEs benefit under a plan (or disaggregated plan), the plan is deemed to satisfy coverage.

Consistency Among Disaggregated Portions Not Required

When a plan is disaggregated into separate plans for coverage testing under otherwise excludable disaggregation rules, the otherwise excludable employee disaggregation election applies separately to each of those disaggregated portions of the plan. Therefore, for example, a plan can disaggregate the otherwise excludable employees for purposes of the coverage testing for the

401(m) portion of the plan without doing so for the 401(a) portion or the 401(k) portion of the plan.

EXAMPLE 2-10. 401(k) Plan. A 401(k) plan consists of three disaggregated components - a 401(k) arrangement, a 401(m) arrangement and employer nonelective contributions (i.e., a 401(a) plan).

These three components are tested separately for coverage. The employer elects to disaggregate otherwise excludable employees for the 401(k) and 401(m) components. However, the employer does not elect to disaggregate otherwise excludable employees for the 401(a) component.

There will be five coverage tests performed with respect to the 401(k) plan for this plan year. For the 401(k) arrangement, there are two coverage tests—one for the otherwise excludable employees and one for the statutory employees. For the 401(m) arrangement, there are also two coverage tests— one for the otherwise excludable employees and one for the statutory employees. However, for the 401(a) component, there is only one coverage test. When determining the coverage testing group for the 401(a) component, only employees who fail to satisfy the lowest age and service requirements of the plan are excludable employees.

Consistency Between Coverage and Nondiscrimination Testing Required

If plans are disaggregated under this otherwise excludable testing rule for coverage purposes, then nondiscrimination testing (e.g., ADP and ACP) also must be performed separately for statutory employees and otherwise excludable employees.

Dual Eligibility

When a plan has more than one set of eligibility requirements that apply to employees covered by the plan, the plan has **dual eligibility** provisions. To determine excludable employees under that type of plan, the exclusion for employees who fail to satisfy the plan's age/service requirements applies to the lowest age/service requirements applicable to any employee benefiting under the plan for the plan year.[18]

2.04: Actual Deferral Percentage (ADP) Test

The **actual deferral percentage** (ADP) test is the exclusive means of showing that the 401(k) arrangement satisfies the nondiscrimination requirements of IRC §401(a)(4).[19] This means that the

[18] Treas. Reg. §1.410(b)-6(b)(2).
[19] Treas. Reg. §1.401(k)-1(b)(1).

employer may not use one of the testing methods available under the IRC §401(a)(4) regulations to show that the amount of elective deferrals is nondiscriminatory.

DESCRIPTION OF THE ADP TEST

The ADP test is performed on the basis of the plan year to determine if the HCE group has exceeded the ADP limit for that plan year. The ADP for a group is determined by averaging the **actual deferral ratios** (ADRs) separately calculated for the eligible employees in the relevant group.

A participant's ADR is the percentage of his or her compensation that has been deferred to the plan through the 401(k) arrangement. The term "elective deferrals" for ADP testing purposes includes pre-tax elective contributions and designated Roth contributions, but does not include catch-up contributions. One ADP is calculated for the eligible employees who are in the HCE group and another ADP is calculated for the eligible employees who are in the NHCE group.

The purpose of the ADP test is to set a limit on the ADP for the HCE group. To pass the test, the ADP of the HCE group must be within a certain range of the ADP of the NHCE group. This analysis is accomplished by requiring that the ADP of the HCE group satisfy either the 1.25 test or the 2 percent spread test.[20] Because the plan needs to pass only one of the two tests, the greater of the two results under these tests sets the limit for the ADP of the HCE group.

1.25 Test

The 1.25 test is satisfied if the ADP of the HCE group does not exceed 1.25 times the ADP of the NHCE group. For example, if the ADP of the NHCE group is 4 percent, the ADP of the HCE group would be limited to 1.25 x 4%, or 5 percent under the 1.25 test.

2 Percent Spread Test

The 2 percent spread test is satisfied if the ADP of the HCE group is both:

- not more than two percentage points greater than the ADP of the NHCE group; and
- not more than twice the ADP of the NHCE group.

In other words, to arrive at the limit for the HCE group, add 2 percent to the NHCE group's percentage or double that percentage, whichever produces the smaller result.

EXAMPLE 2-11. Adding 2 Percent Produces a Lesser Result. The ADP of the NHCE group is 3 percent. The ADP of the HCE group is limited to 5 percent under this test, because adding 2 percent to 3 percent (5 percent) produces a smaller result than doubling 3 percent (6 percent).

EXAMPLE 2-12. Multiplying the HCE by Two Produces a Lesser Result. The ADP of the NHCE group is 1.5 percent. The ADP of the HCE group is

[20] IRC §401(k)(3)(A)(ii).

limited to 3 percent under this test, because doubling 1.5 percent (3 percent) produces a smaller result than adding 2 percent to 1.5 percent (3.5 percent).

Testing Rule – Which Test Produces the Better Results?

If one examines the results of the various tests, a general rule emerges:

- If the ADP of the NHCE group is equal to or less than 2 percent, double that percentage to arrive at the limit for the HCE group.
- If the ADP of the NHCE group is between 2 percent and 8 percent, add two percentage points to determine the maximum for the HCE group.
- If the ADP of the NHCE group is greater than 8 percent, the 1.25 test produces the better result and sets the limit for the HCE group.

SIMPLE 401(k) Plans and Safe Harbor 401(k) Plans

The ADP test is not performed for a SIMPLE 401(k) plan or for a safe harbor 401(k) plan(including a qualified automatic contribution arrangement – QACA), because those plans are deemed to pass the ADP test.

ADMINISTERING THE ADP TEST

The plan administrator is responsible for determining whether the plan passes the ADP test and for taking corrective action, if necessary. The administrator may devote in-house resources to perform the test, or retain a third-party provider to perform this administrative function.

Testing Method

The ADP test has to be run by using either the prior year testing method or the current year testing method. If the prior year testing method is used, then the ADP limit on the HCEs is based on NHCE data from the prior plan year. If the current year testing method is used, then the ADP limit on the HCEs is based on NHCE data from the current plan year. Note that the testing method (i.e., either prior year or current year) refers only to the year of the NHCE data being used. Current year data is always used for the HCEs, regardless of which testing method is being used.

EXAMPLE 2-13. Prior Year Testing Method. A 401(k) plan has a plan year ending December 31. For the plan year ending December 31, 2019, the prior year testing method is being used to run the ADP test. The ADP limit on the HCEs for the 2019 plan year is based on the NHCE data from the 2018 plan year. Therefore, the ADP test described above is applied by averaging the ADRs of the eligible NHCEs for the 2018 plan year (the prior year) and comparing them to the average of the HCE ADRs for the current year (2019).

EXAMPLE 2-14. Current Year Testing Method. Suppose, in the prior EXAMPLE 2-13, that the current year testing method is being used instead. In that case, the ADP limit on the HCEs for the 2019 plan year is based on the

NHCE data from that same plan year. Therefore, the ADP test is applied by averaging the ADRs of the eligible NHCEs for the 2019 plan year.

What if the ADP Test Is Failed?

If the plan fails the ADP test for a plan year, corrective action must be taken during the 12-month period that follows the close of the plan year. Rules for correcting violations of the ADP test are discussed in the next chapter.

2.05: Actual Contribution Percentage (ACP) Test

The **actual contribution percentage** (ACP) test applies to the 401(m) arrangement in a qualified plan. A plan that includes employer matching contributions and/or after-tax employee contributions has a 401(m) arrangement.[21]

In a defined contribution plan, the ACP test is the exclusive means of showing that the 401(m) arrangement satisfies the nondiscrimination requirements of IRC §401(a)(4).[22] This means the employer may not use one of the testing methods available under the IRC §401(a)(4) regulations to show the amount of employer matching contributions or after-tax employee contributions is nondiscriminatory.

DESCRIPTION OF THE ACP TEST

The ACP test is performed on the basis of the plan year to determine if the HCE group has exceeded the ACP limit for that plan year. The ACP is determined by averaging the actual contribution ratios (ACRs) separately calculated for the eligible employees in the 401(m) arrangement. One ACP is calculated for the eligible employees who are in the HCE group and another ACP is calculated for the eligible employees who are in the NHCE group.

The purpose of the ACP test is to set a limit on the ACP for the HCE group. To pass the test, the ACP of the HCE group must satisfy either the 1.25 test or the 2 percent spread test.[23] Because the

[21] Treas. Reg. §1.401(m)-1(a)(3)(i).
[22] Treas. Reg. §1.401(m)-1(a)(1).
[23] IRC §401(m)(2)(A).

plan need pass only one of the two tests, the greater of the two results under both tests sets the limit for the ACP of the HCE group.

These tests are determined in the same manner as under the ADP test.

1.25 Test

The 1.25 test is satisfied if the ACP of the HCE group does not exceed 1.25 times the ACP of the NHCE group. For example, if the ACP of the NHCE group is 4 percent, the ACP of the HCE group would be limited to 1.25 x 4%, or 5 percent under the 1.25 test.

2 Percent Spread Test

The 2 percent spread test is satisfied if the ACP of the HCE group is both:

- not more than two percentage points greater than the ACP of the NHCE group; and
- not more than twice the ACP of the NHCE group.

In other words, to arrive at the limit for the HCE group, add 2 percent to the NHCE group's percentage or double that percentage, whichever produces the smaller result.

Testing Rule – Which Test Produces the Better Results?

As with the ADP test, the general rules for which test is better are as follows:

- If the ACP of the NHCE group is equal to or less than 2 percent, double that percentage to arrive at the limit for the HCE group.
- If the ACP of the NHCE group is between 2 percent and 8 percent, add two percentage points to determine the maximum for the HCE group.
- If the ACP of the NHCE group is greater than 8 percent, the 1.25 test produces the better result and sets the limit for the HCE group.

If You're Curious …

SIMPLE 401(k) Plans and Safe Harbor 401(k) Plans

Employer matching contributions under a SIMPLE 401(k) plan are deemed to satisfy the ACP test. If a safe harbor 401(k) plan (or QACA) includes employer matching contributions, the employer matching contributions are deemed to satisfy the ACP test if certain requirements are satisfied.

After-tax employee contributions are not permitted under SIMPLE 401(k) plans. However, if such contributions are made to a safe harbor 401(k) plan, that plan would be subject to the ACP test, at least on those after-tax employee contributions. If an ACP test has to be performed under a safe harbor 401(k) plan, special rules apply.

Certain Governmental Plans

A governmental plan maintained by a state or local government (or political subdivision, agency or instrumentality of the state or local government) is deemed to pass the ACP

test, even if the employer matching contributions and after-tax employee contributions would not actually have passed this test.[24]

ADMINISTERING THE ACP TEST

The plan administrator is responsible for determining whether the plan passes the ACP test and for taking corrective action, if necessary. The administrator may devote in-house resources to perform the test, or retain a third-party provider to perform this administrative function.

Testing Method

As with the ADP test, the ACP test has to be run by using either the prior year testing method or the current year testing method. If the prior year testing method is used, then the ACP limit on the HCEs is based on NHCE data from the prior plan year. If the current year testing method is used, then the ACP limit on the HCEs is based on NHCE data from the current plan year. Again, the testing method (i.e., either prior year or current year) refers only to the year of the NHCE data being used. Current year data is always used for the HCEs, regardless of which testing method is being used.

What if the ACP Test Is Failed?

If the plan fails the ACP test for a plan year, corrective action must be taken during the 12-month period that follows the close of the plan year. Rules for correcting violations of the ACP test are discussed in the next chapter.

2.06: Choosing the Testing Method for the ADP and ACP Tests

As mentioned above, the ADP test and the ACP test may be run by using either the prior year testing method or the current year testing method.[25] The primary difference between the two methods is that the prior year testing method looks at the NHCE data from the prior plan year to determine the applicable limit on the ADP or ACP of the HCEs for the current plan year (i.e., the testing year), whereas the current year testing method looks at the NHCE data for the current plan year to determine the applicable limit on the ADP or ACP of the HCEs for the current plan year. In other words, the designation of the testing method as prior year or current year, is really a reference to the plan year from which the plan obtains the relevant NHCE data that determine the maximum ADP or ACP for the HCEs.

PRIOR YEAR TESTING METHOD

The default testing method under the statute is the prior year testing method.[26]26 Under the prior year testing method, the ADP limit and ACP limit for the HCEs is determined with reference to

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[24] Taxpayer Relief Act of 1997 (TRA '97), §1505 and IRS Notice 2003-6.
[25] IRC §401(k)(3).
[26] Treas. Reg. §§1.401(k)-2(c) and 1.401(m)-2(c).

NHCE data from the prior plan year. The regulations refer to the plan year from which NHCE data is taken as the applicable year. Notwithstanding the statutory default language, the regulations to IRC §401(k) require that the plan document specify whether prior year testing or current year testing will be used for the plan.[27]

Predictability of Results

The use of prior year data for the NHCE adds predictability to the ADP and ACP test results for a plan year. The applicable ADP and ACP for the NHCE group can be calculated early in the plan year, once the final data for the prior year is known. This way, the employer can use that percentage to determine the ADP limit and ACP limit for the HCE group for the current plan year and do preliminary testing of the HCE group.

These limits may also be communicated to the HCE group, helping to limit the rate of deferral or match for those individuals to avoid requiring corrections in the first part of the following year. As a result, plans that use the prior year testing method may find that incidents of failing the ADP test or ACP test are fewer in number, and those that still fail usually have a lesser margin of failure than they had under current year testing and, therefore, lower required refunds.

The employer can also use the results from the prior year to determine if an allocation of a QNEC to the NHCEs would permit the HCEs to establish a higher rate of deferral and receive an increased matching contribution. Nonetheless, the prior year testing method is not for everyone and, as is detailed in other sections of this chapter, may require the implementation of special rules, particularly in the first plan year that a change from using the current year testing method to using the prior year testing method goes into effect under the plan.

Determination of ADP for NHCE Group Under Prior Year Testing Method

When the prior year testing method is used for the ADP test, all ADP determinations for the NHCE group are made for the prior plan year.[28]

Eligible Group

The NHCEs taken into account under the ADP test performed for the plan year are the eligible employees for ADP test purposes for the prior plan year who were NHCEs for such prior year. Whether these employees are still NHCEs in the current year or are even eligible for the 401(k) arrangement in the current plan year is irrelevant, because all data is taken from the prior plan year for the NHCE group.

Computation of ADRs

To compute the ADP of the NHCE group for the prior plan year, the elective deferral and compensation amounts for the prior plan year are taken into account for each eligible employee included in that group. In other words, the ADRs of the NHCE group for the current plan year (i.e., the year that the test is being performed) are ignored for the ADP test performed for the current

[27] Treas. Reg. §1.401(k)-1(e)(7); see also Treas. Reg. §1.401(m)-1(b)(2).

[28] Treas. Reg. §1.401(k)-2(a)(2)(ii).

year, because data for the NHCE group is taken from the prior plan year. Instead, the current year percentages will become the next plan year's prior year percentages in performing the ADP test for that year under the prior year testing method.

Determination of ACP for NHCE Group Under Prior Year Testing Method

As with the ADP test, when the prior year testing method is used for the ACP test, all ACP determinations for the NHCE group are made for the prior year.[29]

Eligible Group

The NHCEs taken into account under the ACP test performed for the testing year are the eligible employees for ACP test purposes for the prior plan year who were NHCEs in that prior year. As with the ADP, the status of these individuals as eligible employees or NHCEs in the current plan year is completely irrelevant. All data is taken from the prior plan year for the NHCE group.

Computation of ACRs

To compute the ACP of the NHCE group for the prior plan year, the contribution and compensation amounts for the prior plan year are taken into account for each eligible employee included in that group. In other words, the ACRs of the NHCE group for the current plan year (i.e., the year that the test is being performed) are ignored for the ACP test performed for the current year, because data for the NHCE group is taken from the prior plan year. Instead, the current year percentages will become the next plan year's prior year percentages in performing the ADP test for that year under the prior year testing method.

Special Considerations for Discretionary Matching Contribution Formula

The prior year testing method may not be compatible with a discretionary matching contribution formula, particularly if the employer matching contribution rate fluctuates significantly from year to year. For example, suppose in the 2019 plan year, the employer chose not to match elective contributions. If the prior year testing method is used for the 2020 plan year, the prior year ACP of the NHCEs would be zero percent (assuming no after-tax employee contributions were made). When the ACP of the NHCEs is zero percent, the ACP limit for the HCEs is zero percent. If the employer makes employer matching contributions for the 2020 plan year, all of the employer matching contributions allocated to the HCEs would violate the ACP test unless the current year testing method is used.

Determining NHCE Status of the Prior Year Group

Whether an employee is an NHCE or an HCE for the prior plan year is determined on the basis of the workforce in that prior plan year and the definition of HCE in effect in that prior year. It is possible that an employee could be an HCE in the current plan year, but was an NHCE for the

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[29] Treas. Reg. §1.401(m)-2(a)(2)(ii).

prior plan year. In that case, if the plan is using the prior year testing method, the employee is reflected in both groups with respect to that year's test.

If the prior year testing method is used for the ADP test, the employee's ADR for the current plan year is included in calculating the ADP of the HCE group, and the employee's ADR from the prior plan year is included in calculating the ADP of the NHCE group. Similarly, if the prior year testing method is used for the ACP test, the employee's ACR for the current plan year is included in calculating the ACP of the HCE group, and the employee's ACR from the prior plan year is included in the ACP of the NHCE group.

Illustration of Plan That Uses Prior Year Testing Method on a Consistent Basis

The following table shows the ADP results for a plan that uses the prior year testing method on a consistent basis. The years shown in the first column represent the plan year being tested and is the plan year that begins in the calendar year shown. The applicable year for the NHCEs is the prior plan year (i.e., the plan year that begins in the prior calendar year), and those years are shown in the second column. For example, in the second data row of the table is the NHCE data for the 2018 plan year, which is the prior plan year for the plan year being tested (i.e., 2019, as reflected in the first column), and is used to limit the ADP for the HCEs for the 2019 year (final column).

Plan Year Being Tested	Plan Year of NHCE Data	ADP of NHCEs	Maximum ADP for the HCEs
2018	2017	3.2%	5.2%
2019	2018	3.6%	5.6%
2020	2019	2.9%	4.9%
2021	2020	3.5%	5.5%

For each plan year in the first column, the employer is able to communicate a limit to the HCEs well before the year ends (usually by the second or third month of the plan year). For example, for the 2018 plan year, the HCEs know that the average of their ADRs may not exceed 5.2 percent, regardless of what the NHCEs actually contribute during that plan year. This is because the applicable year for determining the ADP of the NHCE group is the prior plan year (i.e., the 2017 plan year) and, as shown in the third column, the ADP of the NHCEs for that year is 3.2 percent. (This does not mean that each HCE is limited to 5.2 percent—it simply means that the average of the HCEs' ADRs for the 2018 plan year cannot exceed 5.2 percent. However, if desired, the plan could contain an individual limit on the HCEs that is correlated to the maximum percentage under the ADP test for that year.)

In the 2018 plan year, the NHCEs actually contribute an average of 3.6 percent (see column three of the second data line of the table). If the plan were to use the current year testing method instead, the ADP of the HCEs could be limited to 5.6 percent, rather than 5.2 percent, based on the 2018 ADP of the NHCEs. Although this might be advantageous for the 2018 plan year, it would be disadvantageous for the 2019 plan year to use the current year testing method, because the ADP of the NHCE group for 2019 is only 2.9 percent, which yields a limit on the HCEs' ADP of only

4.9 percent. Compare this to the limit on the ADP of the HCE group for the 2019 plan year under the prior year testing method, which is 5.6 percent.

One potential drawback to the use of the prior year testing method is that, if the IRS audits the plan, the IRS informally indicated that it will need to open two plan years for audit purposes.[30] The IRS noted that, because the ADP test and/or the ACP test results for a plan year are based on data for a prior plan year, it would need to look at the underlying data from that prior year to determine if the tests were applied correctly.

CURRENT YEAR TESTING METHOD

The alternative to using the prior year testing method is the current year testing method. Under the current year testing method, the ADP limit and ACP limit for the HCEs is determined with reference to NHCE data for the same plan year.

Determination of ADP for NHCE Group Under Current Year Testing Method

When the current year testing method is used for the ADP test, all ADP determinations for the NHCE group are made for the current plan year. These determinations include the following:

Eligible Group

The NHCEs taken into account under the ADP test performed for the plan year are the eligible employees for the current plan year who are NHCEs for such year.

Computation of ACRs

To compute the ACP of the NHCE group for the current plan year, the contribution and compensation amounts for the current year are taken into account for each eligible employee included in that group

Determining NHCE Status of the Current Year Group

Whether an employee is an NHCE or an HCE for the current plan year is determined on the basis of the workforce in that year and the definition of HCE in effect in that year. It is not possible for an employee to be in both groups taken into account under the test, as was the case with the prior year testing method. The data for both groups is taken from the current plan year under the current

[30] IRS "Q&A" session at the 1999 ASPPA Conference, Q&A-41.

year testing method, and it is not possible that an employee can be classified both as an HCE and as an NHCE for the same year.

Predictability Is Sacrificed

When the plan uses the current year testing method for the ADP test or ACP test, the plan does not have the same predictability with respect to the applicable limit on the HCEs. This is not to say that a plan using the current year testing method cannot do any monitoring of the test results during the year. Certainly, the written elections of the NHCE group can be examined periodically during the year (e.g., mid-year or quarterly interim testing) to see if the HCE group is on track to pass the applicable test. However, it is possible that the ADP (or ACP) of the NHCE group will change toward the end of the year (e.g., in the fourth quarter of the plan year, the ADP or ACP of the NHCE group may be significantly reduced, due to a reduction in force of a large number of NHCEs during the last quarter of the year), resulting in a failure of the ADP test (or ACP test). To address this issue, the plan may be designed to limit the frequency with which employees can change their elections (e.g., once per quarter), or it may be designed to automatically reduce the ADRs of the HCEs for the rest of the plan year [under a prescribed formula, so the plan's allocation formula is a definite formula, as required by Treas. Reg. §1.401-1(b)(1)].

Illustration of Plan That Uses Current Year Testing Method on a Consistent Basis

The following tables show the ADP results for a plan that uses the current year testing method on a consistent basis. Note that the plan years shown in the first column are the same as the plan years shown in the second column, because the applicable year for determining NHCE data is the same as the plan year for which the test is performed. This is the same sample employer that was used in the illustration above, except that the above illustration assumed the prior year testing method was in effect, so the plan years shown in the first column were one year behind the plan years shown in the second column. Compare the limit on the HCEs for each year under this table with the limit on the HCEs for each year under the table in the prior illustration.

Plan Year Being Tested	Plan Year of NHCE Data	ADP of NHCEs	Maximum ADP for the HCEs
2018	2018	3.6%	5.6%
2019	2019	2.9%	4.9%
2020	2020	3.5%	5.5%
2021	2021	3.9%	5.9%

For each plan year shown in the first column, the employer is not able to make a final determination of the limit on the HCEs until after the plan year ends, because the limit is based on current year data for the NHCEs shown in the third column. However, preliminary testing may be done during the plan year to obtain a reasonable estimate of the limit.

Note that, for the 2019 plan year, the HCE limit is 4.9 percent because the ADP for the NHCEs that year is only 2.9 percent. Under the prior year testing method, the limit would have been 5.6 percent for the 2019 plan year because the ADP for the NHCEs in the 2018 plan year (i.e., the

prior plan year) was 3.6 percent. By the same token, for the 2020 plan year, the HCEs' limit is 5.5 percent under the current year method because the ADP for the NHCEs for that year is 3.5 percent, but if the prior year testing method were used for the 2020 plan year, the HCEs' limit would be only 4.9 percent because the prior year ADP for the NHCEs (from the 2019 plan year) was only 2.9 percent.

HOW IS IT DETERMINED WHICH TESTING METHOD APPLIES?

As mentioned above, the IRC provides that the prior year testing method applies for ADP testing purposes unless the employer elects to use the current year testing method.[31] Similarly, the IRC specifies that the prior year testing method applies for ACP testing purposes unless the employer elects to use the current year testing method.[32] Treasury regulations have interpreted this to require that a plan document must specify which testing method applies.[33] This will help limit the frequency with which a plan might change its testing method, because a plan amendment will be necessary to make the change. For a third-party service provider that performs testing services for a plan, the plan document will make it clear which testing method must be used.[34]

The statute does not require that, if the prior year testing method is used for the ADP test, the prior year testing method also must be used for the ACP test. In other words, prior year data could be used to calculate the ADP of the NHCEs, but current year data could be used to calculate the ACP of the NHCEs, or vice versa.

As mentioned earlier, a discretionary matching contribution formula may make it difficult to use the prior year testing method because of differences between the current year's rate of match and the prior year's rate of match. Nonetheless, the employer may prefer the predictability of the prior year testing method for ADP purposes. In such case, the plan might specify that the prior year testing method is used for the ADP test but the current year testing method is used for the ACP test.

A plan administrator has a number of testing techniques available to help pass the ADP test, including the testing of certain employer matching contributions, known as QMACs, under the ADP test, and the shifting of elective deferrals into the ACP test. When the plan is using either of

[31] IRC §401(k)(3)(A).
[32] IRC §401(m)(2)(A).
[33] Treas. Reg. §1.401(k)-1(e)(7).
[34] Treas. Reg. §1.401(k)-2(c)(3) and §1.401(m)-2(c)(3).

these testing techniques, the ADP test and the ACP test must be run using the same testing method.[35]

All pre-approved plans may permit prior year testing for one of these tests and current year testing for the other.

RULES FOR SWITCHING TESTING METHODS

The regulations specify the rules that must be followed in changing testing methods.[36] These rules would apply whenever the testing method in effect for a plan year is different from the testing method that was used in the prior plan year.

Switching From Prior Year Testing Method to Current Year Testing Method Is Always Permitted

A plan that uses the prior year testing method may switch to the current year testing method in any subsequent year.[37] The only restriction is that the plan must be amended before it can use the current year testing method (and the amendment must be adopted by the end of the year in which the change is effected).[38] Following a switch from the prior year testing method to the current year testing method, the plan will generally have to stay on the current year testing method for at least five plan years before it may switch back to the prior year testing method.

EXAMPLE 2-15. Change of Testing from Prior Year to Current Year. A 401(k) plan provides that the prior year testing method is used to perform the ADP test. A switch to the current year testing method is not precluded, regardless of the number of years the plan has used the prior year testing method. The plan year is the calendar year.

The plan is amended for the 2020 plan year, to change the testing method to the current year testing method. As a result of the amendment, the ADP of the NHCE group for the 2019 plan year is never used for testing purposes. This is because the prior year testing method was used for the 2019 plan year, so the ADP of the NHCE group was determined for the 2018 plan year and current year testing method is used for the 2020 plan year.

Plan Year	Applicable Plan Year for NHCE Data
2019	2018
2020	2020

As the above table shows, the 2019 plan year data for the NHCEs is skipped and never used for ADP testing purposes.

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[35] Treas. Reg. §1.401(k)-2(c)(3) and §1.401(m)-2(c)(3).
[36] Treas. Reg. §1.401(k)-2(c)(1)(ii) and §1.401(m)-2(c)(1).
[37] Treas. Reg. §1.401(k)-2(c)(1)(i).
[38] Rev. Proc. 2005-66.

Switching From Current Year Testing Method to Prior Year Testing Method Is Restricted

If an employer elects to use the current year testing method, it may not change back to using the prior year testing method in subsequent years, except as permitted by the IRS.[39] Similar rules apply to switching from current year to prior year testing with respect to the ACP test.[40] When the plan switches from the current year testing method to the prior year testing method, the NHCE data for a particular plan year is being used twice for testing purposes—once to run the test for the current plan year under the current year testing method, and again to run the test for the next plan year under the prior year testing method. This is illustrated in EXAMPLE 2-16 below.

EXAMPLE 2-16. Use of Data When Testing Method Changes to Prior Year. A 401(k) plan has a December 31 plan year end. The plan provides that the current year testing method is used. The employer amends the plan to switch to the prior year testing method effective for the 2020 plan year. As a result of the amendment, the data for the NHCE group for the 2019 plan year is used twice for testing purposes.

For the 2019 plan year, the limit on the ADP of the HCEs was based on the ADP of the NHCE group for that plan year because the current year testing method was in effect. For the 2020 plan year, due to the plan amendment switching the plan's testing method to the prior year testing method, the limit on the ADP of the HCEs is also based on the ADP of the NHCE group for the 2019 plan year. The same effect occurs with respect to the ACP test when the ACP testing method is switched from the current year method to the prior year method.

The IRS has adopted rules that restrict a plan's ability to switch to the prior year testing method.[41]

The Five-Year Rule

The **five-year rule** is the general rule that an amendment to change from the current year testing method to the prior year testing method is permitted only if the plan used the current year testing method for each of the five preceding plan years (i.e., the five plan years preceding the plan year for which the change to the prior year testing method takes effect).

If the number of years the plan was in existence (or was part of another plan) before the effective date of the amendment is less than five, then the five-year rule is satisfied if the current year testing method was used in all prior plan years.

If, for the plan year of the change, the plan is being aggregated with another plan for testing purposes [as is permitted under the permissive aggregation rules of Treas. Reg. §1.410(b)-7(c)], the five-year rule is not satisfied unless each of the plans being aggregated used the current year

[39] IRC §401(k)(3)(A).
[40] IRC §401(m)(2)(A).
[41] Treas. Reg. §1.401(k)-2(c)(1)(ii) and §1.401(m)-2(c)(1).

testing method for each of the five preceding plan years (or, if less, the number of years since each such plan was in existence, including a year it was part of another plan).

There is an exception to the five-year rule in the case of a transaction described in IRC §410(b)(6)(C)(i) and Treas. Reg. §1.410(b)-2(f) (i.e., an acquisition or disposition of a related group member, or a merger, spin off, asset or stock acquisition, or similar transaction that results in the acquisition or disposition of employees). If, as a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method, then the plan using the current year testing method may switch to the prior year testing method within the IRC §410(b) transition period (i.e., anytime between the date of the business transaction and the last day of the plan year following the year in which the transaction occurs), without regard to how many past years the current year testing method was used.

A safe harbor 401(k) plan does not have to satisfy the ADP test (hence the reference to an ADP safe harbor) if the requirements of IRC §§401(k)(12) or 401(k)(13) are satisfied. For any plan year during which the plan meets the ADP safe harbor, the 401(k) arrangement is treated as having been on the current year testing method for that year for purposes of applying the five-year rule. Similarly, if the employer matching contributions in a safe harbor 401(k) plan satisfy the ACP safe harbor under IRC §401(m)(11) or (12), the 401(m) arrangement is treated as having been under the current year testing method for that plan year.[42]

EXAMPLE 2-17. Change from Safe Harbor 401(k) Plan and Subsequent Change of Testing Method. A 401(k) plan is a safe harbor plan for the 2016, 2017 and 2018 plan years. Starting with the 2019 plan year, the plan is amended to eliminate the safe harbor rules and resume ADP and ACP testing. The plan amendment that removes the safe harbor provisions states that the current year testing method applies for purposes of the ADP and ACP tests. The plan performs ADP and ACP testing using the current year testing method for the 2019 and 2020 plan years. For the 2021 plan year, the employer wants to amend the plan to adopt the prior year testing method.

Is this amendment permissible? Yes! The plan satisfies the five-year rule. The 2016-2018 plan years are treated as plan years in which the plan used the current year testing method because the plan was a safe harbor 401(k) plan for those years. Thus, the plan has used the current year testing method for five years in a row (2016-2020 plan years), and is eligible to switch to the prior year testing method for the 2021 plan year.

Could the plan in **EXAMPLE 2-17** have used the prior year testing method for the 2019 plan year (i.e., the plan year following the last year in which the safe harbor rules applied)? That depends. If the 2016 plan year was the first year of the 401(k) arrangement, then the plan could use the prior year testing method, because the current year method was deemed to be in effect since the inception of the plan, which satisfies the five-year rule. However, if the 401(k) arrangement had been in existence before 2016, then the current year testing method would have to have been in

[42] Treas. Reg. §1.401(k)-2(c)(1)(i) and §1.401(m)-2(c)(1).

effect for the 2014 and 2015 plan years, in addition to the three deemed years (2016-2018) under the current year testing method, for the five-year rule to be satisfied.

The rule for safe harbor 401(k) plans also applies to any plan year in which the 401(k) plan is a SIMPLE 401(k) plan. For such year, the plan is treated as having used the current year testing method.[43]

Switching from the current year testing method to the prior year testing method is not permitted under any other circumstances.

Remember that the rules above apply only to switching the testing method from the current year testing method to the prior year testing method. The plan is always permitted to switch from the prior year testing method to the current year testing method, as described above.

Anti-abuse Standard for Repeated Changes

The IRS warns that the employer may not manipulate changes in testing methods and other plan provisions to inappropriately inflate the prior year ADP or ACP of the NHCEs. This is commonly referred to as the anti-abuse rule.[44] The IRS will not treat a plan as satisfying the ADP test or ACP test if there are repeated changes in plan testing procedures or plan provisions that have the effect of distorting the test so as to increase significantly the permitted ADP or ACP for the HCEs. It is clear that the IRS anticipates that a plan will settle into a particular testing method, and not change that method too often, even if the switch would not run afoul of the rules described above. Also, the restrictive conditions described above will preclude frequent changes in the testing method so it seems unlikely that an abuse situation would arise.

2.07: Performing the ADP Test

OVERVIEW OF ADP CALCULATIONS

The ADP of the NHCEs is the average of the individual ADRs of the eligible NHCEs. If the prior year testing method is used, the data needed to calculate these percentages is taken from the prior plan year. If the current year testing method is used, the data needed to calculate these percentages is taken from the current plan year.

The ADP of the NHCEs is plugged into the ADP test to arrive at the ADP limit on the HCEs. If the ADP of the HCEs does not exceed the ADP limit, the ADP test is passed. If the ADP of the HCEs exceeds the ADP limit, the ADP test is failed.

Similar to the calculation for the NHCEs, the ADP of the HCEs is determined by averaging the individual ADRs of the eligible HCEs. The data for the HCEs is always taken from the current

[43] Treas. Reg. §1.401(k)-2(c)(1)(i) and §1.401(m)-2(c)(1).
[44] Treas. Reg. §1.401(k)-1(b)(3) and §1.401(m)-1(b)(3).

plan year, regardless of whether the prior year testing method or the current year testing method is used to determine the ADP of the NHCEs.

The following determinations must be made to run the ADP test.

- ***Eligible employees.*** Who are eligible employees under the 401(k) arrangement for the plan year?
- ***ADRs.*** The ADR of each eligible participant must be calculated. A participant's ADR is determined by dividing the participant's elective deferral amount by his or her compensation.
- ***Current year eligible employees must be identified regardless of testing method.*** The eligible employees for the current plan year must be determined, even if the prior year testing method is being used.

  This is because the purpose of the ADP test is to limit the ADP of the HCEs for the current plan year, requiring the plan to identify which of the current year's eligible employees are HCEs.

For example, suppose for the 2019 plan year that there are 120 eligible employees under the 401(k) arrangement. Of those 120 eligible employees, 17 are HCEs and 103 are NHCEs. The ADP of the 17 eligible HCEs for the 2019 plan year must satisfy the ADP test. If the current year testing method is used, the determination of whether the ADP of the HCEs for the 2019 plan year passes the ADP test is based on the ADP of the 103 eligible NHCEs for the 2019 plan year. But if the prior year testing method is used, compliance with the ADP test is based on the ADP of the eligible NHCEs for the 2018 plan year, not on the ADP of the 103 eligible NHCEs for the 2019 plan year.

WHO ARE THE ELIGIBLE EMPLOYEES INCLUDED IN THE ADP TEST?

The ADP test includes only the participants who are eligible employees under the 401(k) arrangement. The eligible employees are defined as the participants who are eligible to elect to defer compensation (i.e., make elective contributions) under the 401(k) arrangement for all or a portion of the plan year.[45] It does not matter if the participant actually makes elective deferrals. If an eligible employee chooses not to make elective contributions, his or her ADR is zero percent, unless there are other contributions included in the ADR (such as QNECs).

A participant is treated as an eligible employee if the employee is eligible to make elective contributions for any portion of the plan year, even if employment terminates (voluntarily or involuntarily) during the plan year.

EXAMPLE 2-18. Terminated Employee. Rich is a participant in his employer's 401(k) plan. The plan year is the calendar year. On January 15, Rich terminates employment. He does not make any elective deferrals for the plan year. Rich is an

[45] Treas. Reg. §1.401(k)-6.

eligible employee for the plan year, even though he worked only 15 days of the year.

Remember the ADP test is run on the basis of current year data for the HCE group, but either on prior year data or current year data for the NHCE group, depending on whether the prior year testing method or the current year testing method is used. If the prior year testing method is used, an NHCE who was an eligible employee for the prior plan year is included in the ADP test even if the NHCE is no longer an eligible employee in the current plan year.

EXAMPLE 2-19. Plan Uses Prior Year Testing Method. LeVonn is a participant in a 401(k) plan. He is an NHCE. His employment with the company terminates on March 10, 2020. The plan year is the calendar year. LeVonn is an NHCE in the 2019 plan year and in the 2020 plan year. To perform the ADP test for 2020, the plan uses the prior year testing method (i.e., the limit on the ADP of the HCEs for the 2020 plan year is determined on the basis of the ADP of the NHCEs for the 2019 plan year).

The ADP of the NHCEs for the 2019 plan year is determined by averaging the ADRs of the eligible employees for the 2019 plan year who are NHCEs for that year. Therefore, the ADP of the NHCE group will include LeVonn's ADR for the 2019 plan year because he was an eligible employee for that year.

EXAMPLE 2-20. Plan Uses Current Year Testing Method. Suppose, in the prior **EXAMPLE 2-19**, that the plan uses the current year testing method for the 2020 plan year, rather than the prior year testing method. Now the limit on the ADP of the HCEs is determined by calculating the ADP of the NHCEs for the 2020 plan year. This is determined by averaging the ADRs of the eligible employees for the 2020 plan year who are NHCEs for that year. LeVonn is still included in the ADP test for 2020 because he is an eligible employee for that plan year (albeit eligible for only the first 2½ months of that plan year, because he terminates on March 10, 2020). Although LeVonn's employment terminates during 2020, he is still an eligible employee for part of the year, so he is included in an ADP test that is run under the current year testing method. The only difference between EXAMPLE 2-19 and this **EXAMPLE 2-20** is that, in **EXAMPLE 2-19**, LeVonn’s elective deferrals and compensation for 2019 are used to determine his ADR, whereas in this **EXAMPLE 2-20**, LeVonn's elective deferrals and compensation for 2020 are used to determine his ADR.

EXAMPLE 2-21. Employment Terminates in Prior Plan Year. Now let us consider the ADP test for the 2021 plan year. If the test is run by using the prior year testing method, then LeVonn is included in the ADP test because he was an eligible employee for the prior plan year (i.e., the 2020 plan year). On the other

hand, if the test is run by using the current year testing method, then LeVonn is not included in the ADP test because he is not an eligible employee for the 2021 plan year, because his employment terminated on March 10, 2020.

EXAMPLE 2-22. HCE. In the above examples, if LeVonn were in the HCE group for the years in question, then he would not be included in the 2021 ADP test, no matter which testing method is used. Current year data always is used for HCEs, even if the prior year testing method applies, because the eligible employees for the current year who are HCEs are the ones being limited by the ADP test. For the 2020 plan year's ADP test, LeVonn would be included in the HCE group's ADP because he is an eligible employee for that year, even though his employment terminates during the year. But for the 2021 plan year's ADP test, LeVonn is not included in the HCE group's ADP because he is not an eligible employee for that year, even if the prior year testing method is used for that plan year.

Employees Whose Elective Deferrals Are Suspended

If an employee is suspended from making elective contributions under the 401(k) arrangement, the employee is treated as an eligible employee if the employee otherwise would be eligible to make elective contributions had the suspension not been in effect.[46] Prior to 2020, the most common reason for elective deferrals to be suspended was when a participant took a hardship distribution and the plan followed the "safe harbor" hardship rules in determining whether the distribution was necessary to satisfy the participant's need for funds. Under those rules, elective deferrals to the 401(k) and any other plan of the employer were suspended for six months after the hardship withdrawal was received. Please note that the suspension for taking a hardship distribution was eliminated effective as of January 1, 2020. Elective deferrals may also be suspended when the employee elects not to participate in the plan. In addition, the plan may, by its terms, suspend elective deferrals for other reasons, such as when a loan has been taken by the participant.

Employees Making One-Time, Irrevocable Election Not to Defer

If the employee makes a one-time, irrevocable election not to make a cash or deferred election under the 401(k) plan (or under any cash or deferred arrangement that is part of another plan maintained by the employer, including plans not yet established) for the duration of his or her employment, the employee is not treated as an eligible employee under the 401(k) plan, and is excluded from the ADP test. This rule applies only if the employee makes the election upon

[46] Treas. Reg. §1.401(k)-6.

commencing employment with the employer, or when the employee is first eligible to make a cash or deferred election under any plan maintained by the employer.[47]

The regulations also provide that a cash or deferred arrangement does not exist merely because an employee may elect a specified level (including zero) of employer contributions, if that election is irrevocable and is made no later than the first day the individual is eligible for any plan maintained by the employer.[48] The purpose of this rule is to ensure that the irrevocable election will not cause the employer contributions made on the individual's behalf, pursuant to the election, to be treated as elective contributions. Thus, the existence of such an election does not cause the plan to be treated as having a cash or deferred arrangement. This rule is separate from the rule described in the prior paragraph. The rule in the prior paragraph applies solely to the right to make a cash or deferred election (e.g., salary reduction election) in the future, and goes to the issue of whether the individual is eligible to make elective contributions under the plan.

EXAMPLE 2-24. Irrevocable Election Not to Defer. An employer maintains a profit-sharing plan with a 401(k) arrangement. Shelly is hired on March 1, 2019, and is first eligible to participate in the plan on July 1, 2020. Before July 1, 2020, Shelly makes an irrevocable election not to make a deferral election under the plan nor under any other cash or deferred arrangement maintained by the employer now or in the future. Shelly is not treated as an eligible employee under the 401(k) arrangement for the 2020 plan year or for any subsequent plan year.

EXAMPLE 2-25. Later Election. Assume, in the prior EXAMPLE 2-24, that Shelly does not make an election before July 1, 2020 but instead makes the election on January 1, 2021. Shelly is still treated as an eligible employee for the 2020 plan year, because her irrevocable election not to defer (i.e., make elective contributions) was made after the earliest date (July 1, 2020) on which she was eligible to participate in the 401(k) arrangement. Even in subsequent plan years, Shelly is an eligible employee for ADP purposes.

Because of Shelly's treatment as an eligible employee in the 2020 and subsequent plan years, the plan must take into account Shelly's ADR of zero percent for all subsequent plan years in which she is employed for any portion of the year. This is not a good plan design. If the employer wants to allow employees to make irrevocable elections regarding whether to make elective contributions, the plan's deadline for making such an election should be the first day that the employee is first eligible for a cash or deferred arrangement maintained by the employer.

As discussed earlier, an employee who would otherwise be eligible to participate in the plan but who makes the irrevocable election described above is not treated as an eligible employee. The employee is not excludable from the coverage testing. Therefore, he or she is included in the ratio

[47] Treas. Reg. §1.401(k)-6.
[48] Treas. Reg. §1.401(k)-1(a)(3)(v).

percentage test and is treated as not benefiting under the plan for coverage testing purposes under IRC §410(b).[49]

Effect of IRC §415 Limits

An employee who cannot make elective deferrals because of the limitations under IRC §415, but who would be an eligible employee if the IRC §415 limit did not apply, is treated as an eligible employee.[50] In many cases, the effect of the IRC §415 limit is determined after the employee has already deferred under the plan for the plan year.

Because the annual additions limit under IRC §415(c) is the lesser of 100 percent of IRC §415 compensation or the applicable dollar limit under IRC §415(c)(1)(A), it is somewhat unlikely that a participant's elective deferrals will cause the IRC §415 limit to be exceeded.

DETERMINING THE ADRS

The individual ADR for each eligible employee must be calculated before the ADPs of the HCE and NHCE groups can be determined. An employee's ADR is the employee's elective deferral amount divided by the employee's IRC §414(s) compensation.[51]

Calculating an Employee's Deferral Amount

The elective deferral amount that is used in the numerator of a participant's ADR generally is the total amount of the employee's elective deferrals under the 401(k) arrangement contributed for the relevant plan year. In some cases, amounts other than the elective deferrals are counted in computing an employee's ADR (such as QMACs and QNECs), while some elective contributions are not counted (catch-up contributions).

The individual deferral ratios, and the average of the percentages to arrive at the ADPs for the HCE and NHCE groups, are rounded to the nearest hundredth percentage point.[52]

When determining deferral ratios, catch-up contributions [as described in IRC §414(v)] are not included, but both pre-tax elective contributions and designated Roth contributions (to the extent they are not catch-up contributions) are included.

Some 401(k) plans are structured as automatic enrollment or negative enrollment plans, where an eligible employee is automatically enrolled at a specified elective deferral rate (e.g., 3 percent of compensation). The employee, before the automatic enrollment date, may make a contrary election to have no salary reduction withholding or to have withholding at a rate different from the automatic rate specified in the plan. Even though an employee's elective deferrals might be made under an automatic enrollment feature, without the employee actually making an affirmative election to make elective deferrals, the amounts so contributed are still treated as elective deferrals

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[49] Treas. Reg. §1.410(b)-3(a)(2).
[50] Treas. Reg. §1.401(k)-6, paragraph (2) of the eligible employee definition.
[51] Treas. Reg. §1.401(k)-2(3).
[52] Treas. Reg. §1.401(k)-1(a)(2)(i).

under the 401(k) arrangement. Thus, these amounts are included in the numerator of the ADR and are taken into account in the ADP test.[53]

Catch-Up Contributions

A plan may permit participants who will be at least age 50 by the end of the calendar year to make catch-up contributions. These are elective contributions that exceed a limit, including the IRC §401(a)(30) limit on elective deferrals in a calendar year, the IRC §415 limit on annual additions in a limitation year, or a plan provision that limits elective contributions to an amount that is less than what is legally permitted (i.e., a plan-imposed limit).

If one or more of these limits is exceeded, the excess elective contribution is reclassified as a catch-up contribution to the extent permissible for that year. Catch-up contributions reclassified for this purpose are not included in the affected participant's ADR for the year.

Treatment of Excess Deferrals Under IRC §401(a)(30) for Purposes of ADR

IRC §401(a)(30) limits the amount of elective deferrals that a qualified plan may permit an eligible employee to make in a calendar year. The IRC §401(a)(30) limit is the applicable dollar limit under IRC §402(g)(1)(A) ($19,500 for 2020, subject to cost-of-living adjustments in future years; $26,000 for catch-up eligible participants). Elective contributions that exceed the IRC §401(a)(30) limit are excess deferrals (except to the extent they are properly treated as catch-up contributions). If a participant has excess deferrals for a calendar year, the following rules apply:

- the excess deferrals are excluded from the participant's ADR if he or she is an NHCE, and
- the excess deferrals are included in the participant's ADR if he or she is an HCE.[54]

These rules apply regardless of whether a corrective distribution of the excess deferrals is made on a timely basis (i.e., by April 15 of the following calendar year), pursuant to IRC §402(g)(2).

EXAMPLE 2-26. Excess Deferrals in ADR. Cameron is an HCE by ownership. He is 30 years old. Cameron defers $20,000 during 2020. The IRC §401(a)(30) limit for 2020 is $19,500 (i.e., Cameron has an excess deferral of $500.) Because Cameron is an HCE, his deferral amount includes the excess deferral.

Suppose the plan year ends December 31, and for the year ending December 31, 2020, Cameron's compensation is $200,000. Cameron's ADR is calculated as 10.0 percent (i.e., $20,000/$200,000), not as 9.75 percent ($19,500/$200,000). This is true even if the excess deferral is distributed by April 15, 2021, in accordance with the corrective distribution procedures under IRC §402(g)(2).

The use of 10 percent will increase the ADP of the HCE group. On the other hand, if Cameron was an NHCE, an ADR of 9.75 percent would apply, because

[53] Treas. Reg. §1.401(k)-1(a)(3)(ii).
[54] Treas. Reg. §1.402(g)-1(e)(1)(ii).

the excess deferral is disregarded, even if it is not returned to Cameron in a timely corrective distribution.

If the amount in excess of the IRC §401(a)(30) is properly treated as a catch-up contribution, that amount is disregarded from the ADR, regardless of whether the individual is an HCE or NHCE.

If a participant who is eligible to make catch-up contributions exceeds the IRC §401(a)(30) limit, the first dollars above that limit are treated as satisfying the catch-up limit (unless because of a lesser limit, such as a plan-imposed limit, the catch-up limit has already been reached).[55] Thus, the amount of an HCE's excess deferrals taken into account in the ADP test is determined by disregarding the catch-up contributions.

EXAMPLE 2-27. HCE Exceeds IRC §402(g) Limit But is Eligible for Catch-up. A 401(k) plan permits catch-up contributions. Randy is 55 years old, so he is eligible for the catch-up provision. For 2020, the IRC §402(g) dollar limit is $19,500, and the catch-up limit is $6,500. Randy defers $26,500 into the plan for 2020 (i.e., $500 in excess of the IRC §402(g) dollar limit including catch-up contributions). Randy is an HCE and his 2020 compensation for ADP testing purposes is $140,000. Because Randy is an HCE, his excess deferrals under IRC §402(g) are included in the ADP. Randy's excess deferrals equal only $500, because $6,500 of the amount exceeding $19,500 are catch-up contributions for 2020. Randy's ADR is $20,000/$140,000, or 14.29 percent. The numerator ($20,000) represents his regular deferrals of $19,500, plus his excess deferral ($500), but does not include his catch-up contributions ($6,500).

EXAMPLE 2-28. HCE Exceeds IRC §402(g) Limit and is Not Eligible for Catch-up Provision. Instead of the facts stated in the prior EXAMPLE 2-27, suppose Randy is only 47 years old, so he is not eligible for the plan's catch-up contribution option. Now, the entire $26,500 of Randy's elective deferrals would be included in the ADP test, yielding an ADR of $26,500/$140,000, or 18.93 percent.

Example 2-29. NHCE Exceeds IRC §402(g) Limit. Let us change the facts one more time. Suppose Randy is an NHCE, not an HCE. In that case, his ADR for the 2020 plan year is $19,500/$140,000, or 13.93 percent, regardless of whether the amount of his deferrals in excess of the IRC §401(a)(30) limit are catch-up contributions or excess deferrals.

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[55] Treas. Reg. §1.414(v)-1(b) and (c)(3).

Designated Roth Contributions

Designated Roth contributions under a 401(k) plan, made pursuant to IRC §402A, are subject to the IRC §402(g) dollar limit in the same manner as pre-tax elective contributions. Thus, a participant's pre-tax elective contributions and designated Roth contributions for a calendar year are aggregated to determine whether the IRC §401(a)(30) limit is exceeded. If the aggregate amount exceeds the IRC §402(g) dollar limit, the rules described above apply with respect to the inclusion of the excess deferrals in the ADP test. Excess deferrals may consist of pre-tax elective contributions or designated Roth contributions, depending on the type of elective deferrals the participant has made.

Catch-up Contributions May be Pre-tax or Roth

A participant's catch-up contributions may be designated as pre-tax elective contributions or as Roth contributions. Regardless of the designation, catch-up contributions are not counted in determining whether the participant has exceeded the IRC §402(g) dollar limit.

Catch-up Contributions Resulting from IRC §415(c) Limit

Elective contributions in excess of the IRC §415(c) limit that are properly treated as catch-up contributions are not refunded. As they are catch-up contributions, they are not included in the ADP test.[56]

Inclusion of QNECs and QMACs in Deferral Amount

If the employer makes QNECs for the plan year, those amounts may be treated as deferral amounts to compute the participants' ADRs. Similarly, if the employer makes QMACs for the plan year, those amounts may be treated as deferral amounts to compute the participants' ADRs.[57] QNECs and QMACs must be 100 percent vested and subject to the 401(k) distribution restrictions at the time that they are deposited to the plan.

EXAMPLE 2-30. QNECs. An employer makes QNECs equal to 2 percent of IRC §414(s) compensation for all NHCEs. Cindy's elective deferrals for the plan year equal 1 percent of her IRC §414(s) compensation. Her ADR may be calculated as 3 percent, rather than 1 percent, because the QNECs may be added to the elective deferrals for purposes of the ADP test. (Alternatively, just a portion of the QNECs could be included, raising her ADR above 1 percent but to some level less than 3 percent.)

EXAMPLE 2-31. QMACs. An employer makes QMACs equal to 50 percent of the elective deferrals. Barbara's elective deferrals for the plan year equal 2 percent of her IRC §414(s) compensation. Her allocation of QMACs equals 50 percent of the elective deferrals, or 1 percent of Barbara's IRC §414(s)

[56] Treas. Reg. §1.414(v)-1(d)(2).
[57] Treas. Reg. §1.401(k)-2(a)(6).

compensation. Her ADR may be calculated as 3 percent, rather than 2 percent, because the QMACs may be added to the elective deferrals for purposes of the ADP test. (Alternatively, just a portion of the QMACs could be included, raising her ADR above 2 percent but to some level less than 3 percent.)

The manner in which QMACs are included in the ADP test may help the testing results. There is no requirement that ADP testing results must be helped in order for QMACs to be included in the ADP test. In fact, if all the employer matching contributions satisfy the definition of QMACs, and there are no other contributions (e.g., after-tax employee contributions) that have to be run through an ACP test, some plan administrators move all the QMACs to the ADP test to eliminate the ACP test entirely.

Double-Counting Limits When Plan Switches to Prior Year Testing Method

When a plan switches from using the current year testing method in one year (which we will call Plan Year 1) to using the prior year testing method in the next year (which we will call Plan Year 2), the NHCE data from Plan Year 1 are being used twice for testing purposes: once to run the ADP test for Plan Year 1 under the current year testing method, and again to run the ADP test for Plan Year 2 under the prior year testing method. QNECs may be used in only one year's ADP or ACP test. As a result, the prior year data must be adjusted to disregard QNECs used in the Plan Year 1 testing before the data are used in Plan Year 2 under the prior year testing method to avoid double-counting the QNECs. QNECs not used in the ADP test for Plan Year 1 may be used in the ADP test in Plan Year 2.

If You're Curious …

Elective Deferrals Must Relate to Compensation for the Plan Year

Elective deferrals are included in the ADP test for a plan year only if they relate to compensation that would have been received in the plan year if the participant did not make the election, subject to the special timing rule described below.[58] If the plan is using the prior year testing method, the ADRs for NHCEs are taken from the prior plan year, and this rule would apply with respect to compensation otherwise payable for that prior plan year.

Special Timing Rule: Compensation that Would Have Been Paid Within 2½ Months After Close of Plan Year

If the deferral amount relates to services performed in the plan year, the elective deferral may be treated as deferred for that year if the compensation would have been received within 2½ months after the close of the plan year.[59]

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[58] Treas. Reg. §1.401(k)-2(a)(4)(i)(B)(1).
[59] Treas. Reg. §1.401(k)-2(a)(4)(i)(B)(2).

Compensation paid after the close of the plan year, to the extent attributable to services performed prior to the end of the year, also may be included in a participant's compensation for the plan year for purposes of calculating the participant's ADR.

Participants who receive bonuses within 2½ months after the close of the plan year could make elective deferrals for the prior plan year from those bonuses, if the bonuses related solely to services performed for that prior year.

Example 2-32. Deferrals from Bonuses. A 401(k) plan allows a participant to elect to defer all or a part of a compensation bonus. The plan year ends December 31. Bonuses determined for a plan year are not paid until January or February of the next year. Mary is entitled to a bonus for her services in 2019 in the amount of $20,000. She elects to defer 5 percent of that bonus, or $1,000, to the 401(k) plan. Mary receives the remaining $19,000 of the bonus on January 15, 2020. The plan may treat the amount deferred from that bonus as a deferral for 2019, even though Mary receives the cash portion of the bonus in 2020, because the elective deferrals are made from a bonus that was paid with respect to Mary's services for 2019 and would have otherwise been received as compensation by March 15, 2020 (i.e., 2 ½ months after the close of the plan year).

The employer may prefer to look at all elective deferrals solely on the basis of the year in which the compensation from which the elective deferrals are deducted would otherwise have been paid. This way, the payroll department, for example, would not have to determine whether any portion of elective deferrals made out of compensation paid in the early portion of a year are supposed to relate to the prior year's ADR. In addition, many employers pay bonuses in the same year for which they are determined, or issue a final paycheck to a terminated employee in the same year in which the termination occurs, so issues like those described above rarely arise.

Participant Must Make Deferral Election Before Compensation is Currently Available

An election to defer compensation must be made before the compensation is currently available to the participant. An amount is currently available if it has been paid to the participant, or if the participant is able to receive the compensation at his or her discretion.[60] An amount is not currently available if there is a significant limitation or restriction on the participant's right to receive the amount currently.[61] Also, if the participant under no circumstances may receive the amount before a particular time in the future, the amount is not currently available.

Furthermore, a participant may not defer from compensation that is paid or becomes currently available before the initial adoption of the 401(k) plan.[62]

Treasury Regulations Deposit Timing Rules

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[60] Treas. Reg. §1.401(k)-1(a)(3)(iii).
[61] Treas. Reg. §1.401(k)-1(a)(3)(iv).
[62] Treas. Reg. §1.401(k)-1(a)(3)(iii).

A provision under the Treasury regulations treats a contribution as an elective deferral only if it is deposited after the participant performs the services with respect to which the elective deferral is made (or when the cash or taxable benefit would be currently available, if earlier).[63] In addition, an employer contribution cannot be treated as an employer matching contribution made with respect to an elective deferral if it is contributed before such time.[64] The effect of this rule is to treat any deferral or match that is contributed too early as a deposit of nonelective contributions (e.g., a discretionary contribution to the underlying profit-sharing plan), that would have to be allocated in accordance with the terms of the plan pertaining to such contributions. These regulations were effective for plan years beginning on or after January 1, 2006.[65]

EXAMPLE 2-33. Advance Contribution of Participant Deferrals. Company M has a taxable year ending June 30 and maintains a 401(k) plan with a December 31 plan year end. On June 30, 2019, Company M contributes $100,000, to be allocated as elective deferrals (and related employer matching contributions) for the remainder of the 2019 plan year (i.e., July 1 through December 31, 2019).

The Treasury regulations would apply to this contribution, because the contributions are allocable for the 2019 plan year. Under the regulations, the $100,000 advance contribution made on June 30, 2019, would have to be treated as a nonelective contribution. The employer would still owe the plan contributions for the elective deferrals and employer matching contributions made with respect to compensation for the period July 1 through December 31, 2019, and such contributions would be deductible by Company M for its taxable year ending June 30, 2020.

A contribution of elective deferrals or employer matching contributions is not treated as failing the rule described above merely because contributions for a pay period are occasionally made before the services with respect to that pay period are performed, provided the prefunding is made to accommodate bona fide administrative considerations.[66] The regulations provide, as an example of bona fide administrative considerations, the temporary absence of the bookkeeper (e.g., due to vacation) with responsibility to transmit contributions to the plan. In addition, forfeitures that are allocated as employer matching contributions, or releases from an ESOP suspense account that are allocated as employer matching contributions, do not fail to satisfy this rule merely because they relate to contributions made before the services were performed.[67] The exception for the ESOP suspense account allocation is conditioned upon the contribution being a required payment due under the loan terms and not being made early with a principal purpose of accelerating deductions.

Presumably, if the employer makes an unintentional overcontribution of elective deferrals, the overpayment could be treated as a credit against the next elective deferral or employer matching contribution deposit (a.k.a. a negative contribution), even though the amount would be applied to elective deferrals or employer matching contributions with respect to which the services are performed after the original overpayment was made to

[63] Treas. Reg. §§1.401(k)-1(a)(3)(iii)(C)(1), 1.401(k)-1(a)(3)(vii), Example 3 and Example 4.
[64] Treas. Reg. §1.401(m)-1(a)(2)(iii)(A).
[65] Treas. Reg. §§1.401(k)-1(g)(1) and 1.401(m)-1(d)(1).
[66] Treas. Reg. §§1.401(k)-1(a)(3)(iii)(C)(2) and 1.401(m)-1(a)(2)(iii)(C).
[67] Treas. Reg. §1.401(m)-1(a)(2)(iii)(B).

the plan. This may also be eligible for the bona fide administrative exception. By relying on the bona fide administrative exception, the prefunded amount would not have to be allocated as a nonelective contribution.

Catch-up Contributions Excluded From ADP Test

As discussed earlier, a catch-up eligible participant may make elective contributions that cause him or her to exceed certain plan and statutory limits. One of the statutory limitations referenced in the catch-up rules is the ADP test.[68] Thus, catch-up contributions are disregarded from the ADP test.

ADP Testing Initially Based on Allowable Limits Other than the ADP Limit

If an employee is a catch-up eligible participant, the employee's catch-up contributions initially are only those elective contributions (up to the applicable catch-up limit for the calendar year) that would otherwise cause the individual to exceed the least of the following limits:

i. the IRC §402(g) dollar limit;
ii. the IRC §415 limit; or
iii. a plan-imposed limit (e.g., 15 percent of compensation).

To the extent the elective contributions are identified as catch-up contributions under the preceding sentence, those amounts are disregarded in performing the ADP test, regardless of whether the employee is an HCE or an NHCE.[69] If the test is failed on this basis, the HCE's excess contributions are first recharacterized as catch-up contributions until the excess contributions are fully absorbed as catch-up contributions or the catch-up contribution limit for the year is reached, whichever comes first.

EXAMPLE 2-34. Participant Exceeds IRC §402(g) Limit. A 401(k) plan has a plan year ending December 31. The plan permits catch-up contributions. The IRC §402(g) dollar limit for 2020 is $19,500 and the catch-up limit for 2020 is $6,500. For 2020, a catch-up eligible participant defers $19,700. When performing the ADP test, only $19,500 of this participant's elective deferrals are included in his ADR, because the amount in excess of the $19,500 (i.e., $200) is treated as catch-up contributions. Without the catch-up rules, the participant would not have been able to exceed the IRC §402(g) dollar limit of $19,500. This is true, regardless of whether the participant is an HCE or an NHCE.

What if this participant does not satisfy the age 50 requirement under IRC §414(v)? Then this participant is not eligible to make catch-up contributions and $200 of his or her elective

[68] IRC §414(v)(5).
[69] Treas. Reg. §1.414(v)-1(d)(2)(i).

contributions are treated as excess deferrals under IRC §402(g) and treated in accordance with the rules regarding excess deferrals discussed above.

EXAMPLE 2-35. Participant Exceeds IRC §415 Limit. A 401(k) plan has a plan year ending December 31. The limitation year for IRC §415 purposes is the plan year. The plan permits catch-up contributions. A participant's annual compensation is $200,000. She is over age 50, so she is eligible to make catch-up contributions. For 2020, the employee defers $19,400 to the 401(k) plan. The first 4 percent of compensation (i.e., $8,000) is matched by the employer. The employer also makes a nonelective contribution to the plan. Under the plan's allocation formula, this employee's allocation of nonelective contributions equals 15 percent of compensation, or $30,000. The IRC §415(c) limit for 2020 is $57,000.

If all of the elective contributions were treated as annual additions for IRC §415 purposes, this participant would exceed this limit. Her total elective contributions ($19,400) plus match ($8,000) plus nonelective contributions ($30,000) equal $57,000, so the IRC §415(c) limit is exceeded by $400. Thus, $400 of the participant's elective contributions are catch-up contributions, because they exceed the IRC §415(c) limit. In this case, it is the IRC §415(c) limit that establishes her maximum elective deferrals, not the IRC §402(g) dollar limit. Her elective contributions for 2020 ($19,400) do not exceed the IRC §402(g) limit for that year. The plan includes only $19,000 of her elective deferrals (i.e., $19,400 minus $400) in determining her ADR. The resulting ADR is 9.5 percent ($19,000/$200,000).

EXAMPLE 2-36. Participant Exceeds Plan-Imposed Limit. A 401(k) plan has a plan year ending December 31. The plan limits elective deferrals to 10 percent of compensation, determined on a plan-year basis. The plan allows for catch-up contributions. A catch-up eligible participant has compensation of $90,000 for 2020. He defers $13,000 for 2020. The IRC §415 limit is not exceeded for this participant, taking into account all annual additions for the year.

Under the plan-imposed limit, this participant's elective deferrals are limited to $9,000. However, the participant is eligible to make catch-up contributions up to the 2019 limit ($6,000) in addition to the elective deferrals allowed under the plan-imposed limit. Thus, $4,000 of his elective contributions are catch-up contributions, and only $9,000 of his elective deferrals are included in computing his ADR. In this EXAMPLE 2-36, the plan-imposed limit was less than both the IRC §402(g) dollar limit and the IRC §415 limit, so it determined the amount of the elective contributions treated as catch-up contributions.

Treatment of Designated Roth Contributions

A 401(k) plan may permit participants to make designated Roth contributions. When a plan allows for designated Roth contributions, each participant must designate whether his or her elective

contributions are pre-tax elective contributions or designated Roth contributions.[70] Except for the tax rules relating to withdrawals from the designated Roth account, elective contributions are treated the same under the plan, regardless of whether they are pre-tax elective contributions or designated Roth contributions.

Thus, the ADR will include all elective deferrals (pre-tax and Roth) except for the elective contributions that are disregarded pursuant to any of the rules discussed above. For example, if the total elective contributions exceed the IRC §401(a)(30) limit, they are treated as excess deferrals for ADP testing purposes in accordance with the rules described above, except to the extent such elective contributions are catch-up contributions. This is true, regardless of whether the elective contributions are pre-tax elective contributions or designated Roth contributions.

Individual Exclusion Limit Under IRC §402(g)

The plan's application of the statutory deferral limit is determined under IRC §401(a)(30), even though it is the applicable dollar limit under IRC §402(g)(1)(A) that sets the IRC §401(a)(30) limit. But the individual also has a personal exclusion limit under IRC §402(g) that determines the maximum amount he or she can exclude from gross income on that year's federal income tax return. The maximum amount excludable under IRC §402(g) is the applicable IRC §402(g) dollar limit plus, if applicable, the catch-up contribution limit.[71] Therefore, the IRC §401(a)(30) limit, adjusted for catch-up contributions, as appropriate, applied by the plan, usually matches up with the individual's application of IRC §402(g). However, the individual's personal limit under IRC §402(g) is based on the aggregation of all elective contribution arrangements in which the individual participates for that calendar year, regardless of whether the employers that maintain those arrangements are related under IRC §§414(b), 414(c), 414(m) or 414(o).

Therefore, it is possible an employee's elective contributions under an employer's 401(k) plan will cause that employee to exceed his or her personal IRC §402(g) dollar limit, because of participation in another elective contribution arrangement with an unrelated employer, even though the elective contributions do not exceed the IRC §401(a)(30) limit under the employer's 401(k) plan. In such a case, the personal excess deferral under IRC §402(g) is not treated by the 401(k) plan as an excess deferral for ADP testing purposes.[72]

EXAMPLE 2-37. Participant Exceeds IRC §402(g) Limit, But Not IRC §401(a)(30) Limit. Company A and Company B each sponsor a 401(k) plan with immediate. Sally worked for Company A from January 1, 2020 through June 30, 2020. She earned $100,000 in compensation and made elective deferral contributions to Company A's plan totaling $18,000. On June 30, 2020, Sally terminated employment with Company A and began working for Company B. From July 1, 2020 through December 31, 2020, Sally earned another $100,000 of

[70] IRC §402A(c)(1).
[71] IRC §402(g)(1) and Treas. Reg. §1.402(g)-2.
[72] Treas. Reg. §1.402(g)-1(e)(1)(ii), which, for ADP testing purposes, refers only to excess deferrals under IRC §401(a)(30).

compensation and made elective deferral contributions to Company B's plan totaling $18,000.

Sally exceeded her personal §402(g) limit by making elective deferral contributions totaling $36,000. However, Sally did not exceed the §401(a)(30) limit of either company's plan. For ADP purposes. For ADP testing purposes, Sally's ADR is 18 percent ($18,000/$100,000) in each plan.

Elective Deferrals Shifted to ACP Test Are Disregarded

If certain conditions are met, all or a portion of the eligible employees' elective deferrals may be included in the ACP test.[73] Elective deferrals that are shifted to the ACP are disregarded when computing an employee's ADR.[74]

Participation by HCE in More Than One Plan

If an HCE participates in more than one plan with a 401(k) arrangement with the same or related employer, there is mandatory aggregation of the employee's elective deferrals to determine his or her ADR under each of such plans. Therefore, the ADR of the HCE will include all elective deferrals made to the plan of the employer or a related employer, divided by all compensation earned by the HCE in working for the employer or a related employer.

Elective Contributions Relating to a USERRA-Covered Military Service Period

Under the Uniformed Service Employees Re-employment Rights Act (USERRA), employees whose employment is interrupted by military service may increase the rate of elective contributions when they return to the private sector. This entitles the former service person to make up for lost elective contribution opportunities.

Elective deferrals made by a re-employed participant under USERRA are disregarded in calculating the ADR of the participant for the plan year in which made and for any other plan year.[75] In other words, the make-up deferrals are not counted for the plan year that includes the military service period to which they relate nor to the plan year in which they are actually contributed.

IRC §414(s) Compensation Must Be Used to Calculate ADRs

A participant's compensation for determining the denominator of his or her ADR is his or her IRC §414(s) compensation. The elective deferral amount is divided by IRC §414(s) compensation to arrive at the participant's ADR.[76] The method of determining IRC §414(s) compensation does not have to be the same from year to year, but the method used for a plan year must be applied

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[73] See IRC §401(m)(3).
[74] Treas. Reg. §1.401(m)-2(a)(5)(iv).
[75] IRC §414(u)(1)(C) and Treas. Reg. §1.401(k)-2(a)(5)(v).
[76] Treas. Reg. §1.401(k)-6, Compensation definition.

consistently to all participants. [Note, however, that, if the plan provides for a specific definition of compensation to be used for testing, that definition must be followed, so long as it qualifies as nondiscriminatory under IRC §414(s).]

The definition used also may be a non-safe harbor definition of IRC §414(s) compensation, as long as the definition can satisfy the compensation ratio test.[77] The definition of compensation used for nondiscrimination testing does not need to be the same as that which was used to determine compensation that was eligible for deferral, nor the definition that is used for allocation of nonelective contributions (if any).

IRC §414(s) compensation may be measured on the basis of the plan year or on the basis of the calendar year ending in the plan year.[78]

IRC §414(s) compensation may be determined by grossing up compensation for the elective contributions.[79] Elective contributions for this purpose include 401(k) deferrals, cafeteria plan deferrals (IRC §125), salary reduction for qualified transportation fringe benefits [IRC §132(f)(4)], elective contributions to 403(b) plans and elective contributions to 457 plans. The ADRs may be calculated on the basis of gross compensation or net compensation.

EXAMPLE 2-38. Gross or Net Compensation for Deferrals. Assume a participant's gross compensation is $50,000, and the participant defers $3,000 to the 401(k) plan. There are no contributions made by the participant to a cafeteria plan, 403(b) plan or 457 plan maintained by the employer. The participant's elective deferrals are the only amounts taken into account to determine the participant's ADR. The participant's ADR would be calculated as $3,000/$50,000, or 6 percent, if gross compensation is used. The participant's ADR would be calculated as $3,000/$47,000, or 6.38 percent, if net compensation is used.

The safe harbor definitions of IRC §414(s) compensation would require all elective contributions to be treated uniformly, including cafeteria plan deferrals. In the preceding example, if the participant also defers $1,000 for health insurance benefits under the employer's cafeteria plan, the net compensation would be $46,000, instead of $47,000, resulting in an ADR based on net compensation of 6.52 percent (i.e., $3,000/$46,000). A compensation definition that includes some (but not all) elective contributions may not be used for ADP testing unless the definition satisfies the compensation ratio test. For example, if a participant's compensation includes his or her 401(k) elective deferrals but not cafeteria plan contributions, the compensation definition is not a safe harbor under IRC §414(s) and would have to be tested under IRC §414(s) before it could be used to determine ADRs.

If the ADP for the NHCE group is based on the prior year data (i.e., the prior year testing method is in effect), then consistent application of the IRC §414(s) compensation definition means that the

[77] Treas. Reg. §1.414(s)-1(d)
[78] *Id.*
[79] Treas. Reg. §1.414(s)-1(c).

same definition of IRC §414(s) compensation used to calculate the ADRs of the HCE group for the current year must be used to calculate the ADRs of the NHCE group for the prior year.

Contributions to Nonqualified Deferred Compensation Plan Not Included

IRC §414(s) compensation does not include contributions to a nonqualified deferred compensation plan.[80]

EXAMPLE 2-39. Exclude Nonqualified Deferred Compensation Contributions. Douglas is a participant in a top hat nonqualified deferred compensation plan. He defers $40,000 of compensation into the nonqualified plan. The deferral reduces his compensation from $180,000 to $140,000. Douglas also defers $13,000 into the 401(k) plan, reducing his current compensation to $127,000. Douglas makes no other elective contributions for the year. If net compensation is used to run the ADP test, Douglas' compensation is $127,000. If gross compensation is used, Douglas' compensation is $140,000. The $40,000 that is deferred into the nonqualified plan may not be added to Douglas' compensation to compute his compensation for ADP testing purposes, because nonqualified deferred compensation is not included in the IRC §414(s) compensation definition.

Reminder: Lookback Year Compensation is Always Used to Identify Who is an HCE for the Current Plan Year

Note that an employee's prior year compensation (i.e., compensation for the lookback year) is used to determine his or her status as an HCE, regardless of the testing method used for ADP purposes. The lookback year is generally the 12-month period preceding the first day of the plan year, although for some noncalendar year plans it is the calendar year in which the plan year begins.[81]

EXAMPLE 2-40. Plan Using Current Year Testing Method. A 401(k) plan uses the current year testing method for the plan year beginning January 1, 2020. Manfred is an eligible employee for the 2020 plan year. His compensation for that year is $95,000 and he defers $11,000 for that year. To determine whether Manfred is in the HCE group or in the NHCE group for the 2020 plan year, his compensation for the lookback year is taken into account (i.e., his compensation for the 12 months preceding the 2020 plan year, which is calendar year 2019). Manfred's compensation for 2019 was $88,000. Therefore, Manfred is in the NHCE group for the 2020 plan year, because the HCE compensation test for the lookback year that started in 2019 requires compensation in excess of $125,000. (We are assuming Manfred is not an owner, so he is not in the HCE group by reason of the 5-percent owner test.)

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[80] Treas. Reg. §1.415-2(d)(3)(I) and §1.414(s)-1(c).
[81] IRC §414(q), IRS Notice 97-45.

Because the plan is using the current year testing method, the ADP of the NHCE group is calculated using data for the 2020 plan year. Manfred's ADR is $11,000/$95,000, or 11.58 percent, which is based on his current year deferrals and his current year compensation, and that percentage is averaged with the ADRs of the other eligible NHCEs for the 2020 plan year.

If Manfred's 2019 compensation was greater than $125,000, he would be an HCE for the 2020 plan year [assuming the top-paid group election under IRC §414(q)(1)(B)(ii) does not cause him to be treated as an NHCE], and his ADR for 2019 would be included in computing the ADP of the HCE group instead.

EXAMPLE 2-41. Plan Using Prior Year Testing Method. Assume the same facts as the prior EXAMPLE 2-40, except the plan is using the prior year testing method. Now the plan would compute the ADP of the NHCE group using the 2019 plan year data. Manfred would be included in the ADP of the NHCE group only if he was an eligible employee in the 2019 plan year and, for that plan year, was in the NHCE group (which will be determined by applying the HCE test to the 2019 plan year population, and using the 2018 compensation because the lookback year for the 2019 plan year is 2018). If Manfred was in the NHCE group for the 2019 plan year, his ADR for that plan year would be calculated using his elective deferrals and compensation for 2019, to compute the prior year ADP of the NHCE group for purposes of the 2020 plan year's ADP test.

Compensation may be Limited to Period of Employee's Eligibility

IRC §414(s) compensation may be limited to the period during which the employee is an eligible employee for the plan year (or for the calendar year ending in the plan year, if such measuring period is used instead).[82] If the plan limits compensation to the period of eligibility, such limitation must be applied uniformly to all eligible employees who were eligible for only a portion of the plan year (or calendar year, if applicable). This rule is not mandatory and the compensation for the entire plan year may be used instead for employees who were eligible for only part of the year.

EXAMPLE 2-42. Newly Eligible on Midyear Entry Date. A plan's entry dates are January 1 and July 1. The plan year is the calendar year. The IRC §414(s) compensation for an employee who first becomes eligible on July 1 may be measured from July 1 through December 31. Alternatively, the employee's IRC §414(s) compensation for the entire plan year may be counted.

EXAMPLE 2-43. Ineligible for Part of Year Because of Job Category Exclusion. A plan excludes employees in Division B from participating in the

[82] Treas. Reg. §1.401(k)-6, Compensation definition.

401(k) plan. An eligible employee is transferred to Division B on April 1 and becomes ineligible to defer after that date. The plan year is the calendar year. The transferred employee's IRC §414(s) compensation for the plan year could be limited to compensation from January 1 through March 31. Alternatively, the employee's IRC §414(s) compensation for the entire plan year may be counted.

EXAMPLE 2-44. 401(k) Effective for Only Part of Year. An existing profit-sharing plan is amended to add a 401(k) arrangement effective August 1. The plan year is the calendar year. When calculating a participant's ADR for the plan year, IRC §414(s) compensation may be limited to compensation for the period August 1 to December 31. Alternatively, compensation for the entire 12-month period ending December 31 may be used. The method for measuring compensation must be applied uniformly to all participants.

Remember that a participant's suspension of deferral rights due to loan is disregarded in determining the period for which he or she is an eligible employee.[83] For example, suppose a participant is suspended from deferring until May 1 in a calendar plan year because of a loan. Although the participant could not defer from January 1 through May 1, she is still considered an eligible employee for that period. Therefore, compensation for purposes of computing the participant's ADR for the plan year must be measured for the entire plan year, not from May 1 through December 31 when the suspension was no longer in effect.

If a participant is eligible to defer for the entire plan year, but chooses not to defer for a portion of the year, the entire year's compensation must be taken into account to determine the ADR for that year.

EXAMPLE 2-45. Defer for Part of a Year. A participant is eligible for the company's 401(k) plan as of January 1, which is the first day of the plan year. The participant, however, chooses not to defer until August 1 of that year. The participant's gross compensation for the entire year is $60,000, but for the period from August 1 to December 31 is $26,000. The participant defers $3,000 of her compensation earned from August 1 to December 31. The ADR for the plan year is $3,000/$60,000 or $3,000/$57,000, depending on whether gross or net compensation is used. The ADR may not be computed as $3,000/$26,000 or $3,000/$23,000, to reflect compensation for just the period in which the participant actually elected to defer compensation. Because the participant was eligible to defer for the entire plan year, the entire year's compensation must be used.

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[83] Treas. Reg. §1.401(k)-6, Eligible employee definition.

Dollar Limitation on Compensation Taken into Account

The dollar limitation under IRC §401(a)(17) applies to the IRC §414(s) compensation used to compute the ADRs.

EXAMPLE 2-46. Dollar Limit on Compensation. A 401(k) plan has a plan year ending December 31. For the plan year beginning January 1, 2020, a participant's compensation is $295,000, and the participant defers $14,000 for the plan year. The compensation dollar limitation in effect for 2020 is $285,000. The participant's ADR is calculated as $14,000/$285,000, or 4.9100 percent.

The compensation limit applies to the compensation used in applying the applicable nondiscrimination rule.[84] If gross compensation is used to define IRC §414(s) compensation, the dollar limit will be applied to the gross compensation. If net compensation is used to define IRC §414(s) compensation, the dollar limit will be applied to the net compensation. In other words, if net compensation is used, the dollar limitation is applied after elective contributions are deducted to arrive at net compensation. For example, gross compensation (in EXAMPLE 2-46, $295,000) is reduced by the elective contributions ($14,000, for a net amount of $281,000), and then the limit ($285,000) is applied. Net compensation is not determined by first limiting compensation to $285,000 and then subtracting the participant's elective contributions ($14,000) to arrive at net compensation of $271,000. In EXAMPLE 2-46, the participant's ADR for 2020 is $14,000/$285,000 or 4.9100 percent, regardless of whether gross compensation or net compensation is used to calculate the ADR (because both gross and net compensation exceed the $285,000 compensation limit).

If all or a significant percentage of HCEs have net compensation above the dollar limit, it would be advantageous to use net compensation to compute ADRs because it would increase the ADRs of the NHCEs without affecting the percentages of the HCEs.

If You're Curious …

Short Compensation Periods

If the plan year is a short period (i.e., less than 12 months long), compensation is usually measured for the short period. Where the compensation period is a short plan year, the compensation dollar limit is prorated.[85] For example, if a plan year is only four months long, which is one-third the length of a normal 12-month plan year, then only one-third of the compensation dollar limit is applied to compensation for the short plan year.

An employee's compensation taken into account for a plan year may be limited to the period during which the employee was eligible to participate for that year. However, no proration of the dollar limit is required merely because the employee's compensation taken into account is limited to his or her period of eligibility, provided that the plan year

[84] Treas. Reg. §1.401(a)(17)-1(c)(1).
[85] Treas. Reg. §1.401(a)(17)-1(b)(3)(iii).

is a 12-month period and the compensation period otherwise used for that plan year is also 12 months long.[86]

EXAMPLE 2-47. No Proration. A participant's initial eligibility date is October 1 in a calendar-year plan. The participant's compensation for the period October 1 to December 31 is $65,000. Because the plan year is 12 months long, so that the normal compensation period used for the plan year is also a 12-month period, the compensation dollar limit is not prorated to determine the participant's compensation from October 1 to December 31. Therefore, the entire $65,000 of compensation for the short period is taken into account to determine the participant's ADR for the plan year, even if four times $65,000 exceeds the compensation dollar limit in effect for the plan year.

A 401(k) plan might limit a participant's elective contributions for a plan year to some specified percentage of compensation (e.g., 15 percent of plan year compensation). The plan also might restrict the types of compensation from which a participant may defer. The definition of compensation used for these purposes will not necessarily be the same definition of compensation that will be used to calculate ADRs for ADP testing purposes. Remember, for ADP purposes, the definition of compensation for determining ADR must satisfy IRC §414(s). However, a plan-imposed deferral limit or a plan's definition of compensation eligible for deferral does not have to be based on an IRC §414(s) definition of compensation. Even in a safe harbor 401(k) plan under IRC §401(k)(12), the plan's definition of compensation for these purposes only needs to be based on a definition of compensation that is reasonable under the Treasury Regulations (e.g., base salary that is exclusive of bonuses and overtime),[87] which means it does not have to satisfy the compensation ratio test.[88] However, IRC §414(s) compensation must be used for deferral under a safe harbor plan under IRC §401(k)(13) (i.e., a qualified automatic contribution arrangement).

EXAMPLE 2-48. Definition of Compensation. A 401(k) plan provides that a participant may defer only from base salary, meaning that compensation attributable to bonuses and overtime is disregarded when computing the amount of a participant's elective contribution for the plan year. The plan administrator determines the base salary definition does not satisfy IRC §414(s) because it cannot pass the compensation ratio test.

Julius made a salary reduction election for the plan year to defer 6 percent of base salary. Julius' base salary is $30,000, so his total elective contribution amount for the plan year is $1,800. Julius' total compensation under a definition which satisfies IRC §414(s) is $38,000, because Julius has bonuses and overtime for the plan year totaling $8,000. When the ADP test is run, the plan administrator may not treat Julius' ADR for the plan year as 6 percent. His ADR for ADP purposes is his deferral amount divided by his IRC

[86] Treas. Reg. §1.401(a)(17)-1(b)(3)(iii)(B).
[87] Treas. Reg. §1.414(s)-1(d)(2).
[88] Treas. Reg. §1.401(k)-3(b)(6)(iv).

§414(s) compensation of $38,000, for an ADR of $1,800/$38,000, or 4.74 percent. Alternatively, if net compensation is used, the ADR is $1,800/$36,200, or 4.97 percent.

2.08: Performing the ACP Test

OVERVIEW OF ACP CALCULATIONS

Average of Individual ACRs Determines the ACP

The ACP of the NHCEs is the average of the individual ACRs of the eligible NHCEs. If the prior year testing method is used, the data needed to calculate these percentages is taken from the prior plan year. If the current year testing method is used, the data needed to calculate these percentages is taken from the current plan year.

The ACP of the NHCEs is plugged into the ACP test to arrive at the ACP limit on the HCEs. If the ACP of the HCEs does not exceed the ACP limit, the ACP test is passed. If the ACP of the HCEs exceeds the ACP limit, the ACP test is failed. Similar to the calculation for the NHCEs, the ACP of the HCEs is determined by averaging the ACRs of the eligible HCEs. The data for the HCEs is always taken from the current plan year, regardless of whether the prior year testing method or the current year testing method is used to determine the ACP of the NHCEs.

Required Determinations

The following determinations must be made to run the ACP test.

- ***Eligible employees.*** Who are eligible employees under the 401(m) arrangement for the plan year?
- ***Contribution ratios.*** The ACR of each eligible employee must be calculated. A participant's ACR is determined by dividing his or her contribution amount (attributable to employer matching contributions and after-tax employee contributions) by the participant's compensation.

As with the ADP testing, the eligible employees for the current plan year must be identified, even if the prior year testing method is being used, because the purpose of the ACP test is to limit the ACP of the HCEs for the current plan year.

WHO ARE THE ELIGIBLE EMPLOYEES INCLUDED IN THE ACP TEST?

The ACP test includes only the employees who are eligible employees under the 401(m) arrangement. The eligible employees are defined as the employees who are eligible to make after-

tax employee contributions or who are eligible for an allocation of employer matching contributions for all or a portion of the plan year.[89]

Determining Eligible Employees With Respect to Matching Contributions

A participant is eligible for an allocation of employer matching contributions if the participant is eligible to make the contributions that are matched and the participant satisfies any other allocation conditions for the match. It does not matter whether the participant actually makes the contributions required for an allocation of employer matching contributions.[90]

Effect of Allocation Conditions on the Match

An employer matching contribution may be conditioned on the participant's completion of a minimum-hours-of-service requirement (e.g., 1,000 hours) and/or employment on the last day of the plan year. If the participant does not satisfy the plan's allocation conditions, the participant is not eligible for an employer matching contribution for purposes of determining whether he or she is an eligible employee under the 401(m) arrangement.[91] Because of these allocation conditions on the employer matching contribution, a participant may be an eligible employee under the 401(k) arrangement, and included in the ADP test, but not an eligible employee under the 401(m) arrangement, and excluded from the ACP test (unless the individual is an eligible employee with respect to after-tax employee contributions).

EXAMPLE 2-49. Participant Chooses Not to Defer Under 401(k) Arrangement. Karen is a participant in a 401(k) plan. The plan provides for a 50 percent employer matching contribution on the first 4 percent of compensation deferred under the 401(k) arrangement. A participant does not have to be employed on the last day of the plan year or complete a minimum number of hours of service to receive the employer matching contribution allocation. Karen chooses not to defer for the plan year, so she does not receive any employer matching contribution allocation. Nonetheless, Karen is an eligible employee under the 401(m) arrangement for that plan year because had she made elective contributions; she would have been eligible for an employer matching contribution allocation on those elective contributions. Because she did not make elective contributions, her employer matching contribution allocation is $0, so her ACR is zero percent.

EXAMPLE 2-50. Employment Terminates But Last-day Employment is Not a Condition for Match. Assume in the prior example that Karen terminated employment during the plan year. Karen is still an eligible employee under the 401(m) arrangement because, had she deferred for the plan year, she would have

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[89] Treas. Reg. §1.401(m)-5.
[90] Treas. Reg. §1.401(m)-5, paragraph (1) of the Eligible Employee definition.
[91] Treas. Reg. §1.401(m)-5, paragraph (2) of the Eligible Employee definition.

received an employer matching contribution allocation. The plan does not include a last-day employment requirement for employer matching contributions, so Karen's termination before the end of the year does not affect eligibility for employer matching contributions. Karen’s failure to get a match is solely due to her decision not to make elective contributions for the plan year. Her ACR for the plan year is zero percent.

EXAMPLE 2-51. Employment on Last Day of Plan Year is Condition for Match. Assume in the prior example that employment on the last day of the plan year is an allocation requirement for employer matching contributions. In that case, Karen would not be an eligible employee under the 401(m) arrangement for the plan year in which she terminates. She would be excluded from the test, not counted as a zero percent. Note that Karen would be an eligible employee for the 401(k) arrangement because she was eligible to defer under that arrangement during the plan year. Being employed on the last day of the plan year is only a condition for receiving employer matching contributions, not for electing to defer compensation under the 401(k) arrangement. Also note that Karen would be “non-benefiting” for purposes of the IRC §410(b) test unless she worked less than 500 hours in her year of termination.

EXAMPLE 2-52. Comparison of Eligible Groups under ADP and ACP Test. A 401(k) plan provides for an employer matching contribution, but does not permit after-tax employee contributions. Therefore, the 401(m) arrangement consists solely of employer matching contributions. The plan requires employment on the last day of the plan year to receive an allocation of employer matching contributions. The plan year ends December 31. You have the following statistics for the 2019 plan year.

2019 Plan Year
132 eligible employees for ADP (112 NHCEs; 20 HCEs)
119 eligible employees for ACP (101 NHCEs; 18 HCEs)

The reason why there are fewer eligible employees for the ACP than for the ADP is the last-day employment condition on employer matching contributions. Some of those who may make elective contributions will not be eligible to get an employer matching contribution because they will terminate during the year.

For the 2019 plan year, 13 of the 132 eligible employees terminated during the plan year, leaving only 119 eligible for ACP purposes.

If You're Curious …

Separate Allocation Requirements for Different Portions of the Plan Year

Some plans have multiple allocation periods in a plan year, and the allocation requirements for employer matching contributions are applied separately to each allocation period. Even though eligibility for employer matching contributions might be determined separately for each allocation period, because the ACP test is run on a plan year basis, a participant is an eligible employee for that plan year even if the participant does not meet the allocation requirements in every allocation period included in that year. The failure to satisfy the allocation requirements in some, but not all, allocation periods included in the plan year might affect the amount of compensation used to compute the participant's ACR, because the participant is eligible for a match for only part of the year. However, it does not affect the participant's treatment as an eligible employee for that plan year.

EXAMPLE 2-53. Different Allocation Requirements. A 401(k) plan separately determines eligibility for employer matching contribution for each quarter of the plan year. The plan year ends December 31. To be eligible for employer matching contributions for the first quarter, the participant must be employed on March 31. To be eligible for employer matching contributions for the second quarter, the participant must be employed on June 30. To be eligible for employer matching contributions for the third quarter, the participant must be employed on September 30. To be eligible for employer matching contributions for the fourth quarter, the participant must be employed on December 31.

Jake terminates employment on August 15. As a result, he is not eligible for employer matching contributions for the third quarter of the plan year, even if he has made elective contributions in that third quarter. He also is not eligible for employer matching contributions for the fourth quarter. Nonetheless, Jake is treated as an eligible employee for the plan year because he is eligible for employer matching contributions for the first two quarters of that year.

To calculate Jake's ACR for the plan year, his compensation may be limited to his compensation from January 1 through June 30, because he is not an eligible employee for the third and fourth quarters of the plan year.

Coverage Testing Issue

Allocation conditions on the employer matching contributions may affect whether the 401(m) arrangement satisfies the coverage requirements of IRC §410(b). This is because a participant who is not eligible for employer matching contributions is treated as not benefiting under the plan's 401(m) arrangement (unless the participant is eligible to make after-tax employee contributions).[92]

[92] Treas. Reg. §1.410(b)-3(a)(2)(i).

Determining Eligible Employees With Respect to After-Tax Employee Contributions

A participant is eligible to make after-tax employee contributions if the participant is permitted (or required) under the terms of the plan to make contributions on an after-tax basis, even if the participant chooses not to make such contributions.[93]

EXAMPLE 2-54. 401(k) Plan Permits After-Tax Employee Contributions. A 401(k) plan permits participants to make after-tax employee contributions in addition to, or in lieu of, elective contributions under the 401(k) arrangement. There is no employer matching contribution in the plan. The 401(m) arrangement consists solely of after-tax employee contributions. Any participant who is eligible to make after-tax employee contributions is an eligible employee for ACP purposes.

EXAMPLE 2-55. Matching Contributions in Addition to After-tax Employee Contributions. A 401(k) plan provides for employer matching contributions on elective contributions. A participant must be employed on the last day of the plan year to receive an allocation of employer matching contributions. Eligible employees also may make after-tax employee contributions. The last-day employment rule does not apply to after-tax employee contributions.

The 401(m) arrangement consists of both employer matching contributions and after-tax employee contributions. A participant is an eligible employee for ACP purposes if the participant is eligible to make after-tax employee contributions or to receive an allocation of employer matching contributions. Therefore, even if a participant is not employed on the last day of the plan year, he or she is still an eligible employee for ACP purposes if the plan's eligibility requirements to make after-tax employee contributions have been satisfied, regardless of the fact that the participant is not eligible for an allocation of employer matching contributions.

Suspensions From Participation

A participant is treated as an eligible employee under the 401(m) arrangement for a plan year, even if the participant is suspended from making after-tax employee contributions because of a distribution or loan from the plan or an election not to participate in the plan. The same is true with respect to employer matching contributions. If a participant is unable to receive an allocation of employer matching contributions because the participant is unable to make the type of contributions that are being matched (e.g., elective contributions under a 401(k) arrangement) due to a distribution or loan, the participant is still considered to be an eligible employee with respect

[93] Treas. Reg. §1.401(m)-5, paragraph (1) of the Eligible Employee definition.

to the 401(m) arrangement.[94] This rule parallels the rules for determining eligible employees under a 401(k) arrangement.

Irrevocable Election

The exception for a one-time irrevocable election, as described under the eligible employee definition for the ADP test, also applies to the definition of an eligible employee for the ACP test.[95]

IRC §415 Limits

A participant who cannot make after-tax employee contributions or receive an allocation of employer matching contributions because of the limitations under IRC §415, but who would be an eligible employee if the IRC §415 limits did not apply, is treated as an eligible employee.[96]

Aggregation of All Eligible Employees

If a plan includes both employer matching contributions and after-tax employee contributions, the ACP test includes all eligible employees under the 401(m) arrangement, whether they are eligible employees because of the employer matching contribution feature or the after-tax employee contribution feature. The employer matching contributions and after-tax employee contributions are not subject to separate ACP tests.

If You're Curious …

Employees Eligible to Make Rollover Contributions Before Participation Date

As was discussed earlier with the ADP test, if an employee is eligible to make rollover contributions under the plan, but is not eligible to participate in the plan's 401(m) arrangement at any time during the plan year, the employee is not considered an eligible employee under the 401(m) arrangement. Eligibility to make a rollover contribution does not constitute eligibility for §401(m) purposes.[97]

Employee Who Receives No Compensation for the Plan Year

An employee who receives no compensation for the plan year is probably not considered to be an eligible employee under the plan's 401(m) arrangement, even though the individual technically satisfies the plan's definition of an eligible employee.

Eligibility to Make Deemed IRA Contributions Before Participation Date

A plan may allow for deemed IRAs. If an employee is eligible to make deemed IRA contributions for a plan year, but is not otherwise eligible to participate in the plan's

[94] Treas. Reg. §1.401(m)-5, paragraph (2) of the Eligible Employee definition.
[95] Treas. Reg. §1.401(m)-5, paragraph (3) of the Eligible Employee definition.
[96] Treas. Reg. §1.401(m)-5, paragraph (2) of the Eligible Employee definition.
[97] Rev. Rul. 96-48.

401(m) arrangement at any time during the plan year, the employee should not be treated as an eligible employee for ACP testing purposes. This is the same rule that applies to the ADP test.[98]

CALCULATION OF ACRS

The individual actual contribution ratios (ACRs) for each eligible employee must be calculated before the ACPs for the HCE and NHCE groups can be determined. A participant's ACR is the participant's contribution amount divided by the participant's IRC §414(s) compensation.[99]

The individual ACRs, and the average of the ACRs to arrive at the ACPs for the HCE and NHCE groups, are rounded to the nearest hundredth percentage point.[100]

Calculating a Participant's ACR

As discussed above, a participant's ACR is determined by dividing the participant's contribution amount by compensation.

The contribution amount is generally the total of the employer matching contributions and after-tax employee contributions allocated to the participant for the relevant plan year. The regulations refer to these amounts as aggregate contributions because they represent the aggregate of the employer matching contributions and the after-tax employee contributions. However, the term aggregate contributions is also used even if the 401(m) arrangement under the plan includes only one type of contribution (e.g., just employer matching contributions). In some cases, amounts other than the employer matching contributions and after-tax employee contributions are also counted in computing an employee's ACR.

If the plan allows for catch-up contributions, and a participant's catch-up contributions are matched, such employer matching contributions are included as part of the participant's contribution amount, except to the extent such employer matching contributions are described in the exceptions below.

If the plan allows for forfeitures to be allocated as employer matching contributions, those forfeiture allocations are counted in computing an employee's ACR.

Any employer matching contributions that are QMACs and are treated as deferral amounts under the ADP test are excluded from the ACR.[101] If a 401(k) plan's 401(m) arrangement includes only employer matching contributions, and all the employer matching contributions are QMACs, the ACP test can be eliminated by including all the employer matching contributions in the ADP test. Sometimes QMACs are shifted to the ADP test to correct a failure of the ADP test or to reduce the margin of failure.

Remember that the ACP of the NHCEs is calculated on the basis of the prior year data, if the prior year testing method is used, or on the basis of the current year data, if the current year testing

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[98] IRC §408(q).
[99] Treas. Reg. §1.401(m)-2(a)(3).
[100] Treas. Reg. §1.401(m)-2(a)(2)(i).
[101] Treas. Reg. §1.401(m)-2(a)(5)(iii).

method is used. If the prior year testing method is being used, then QMACs allocated in that prior plan year that were used in the ADP test would be excluded in calculating the prior year ACRs for the NHCEs. If the current year testing method is being used, then QMACs allocated in the current plan year that are used in the ADP test would be excluded in calculating the current-year ACRs for the NHCEs.

Participation by HCE in More than One Plan

If an HCE participates in more than one plan of the same or related employer with a 401(m) arrangement, there is mandatory aggregation of the employee's matching contributions and after-tax employee contributions to determine his or her ACR under each of such plans.

If You're Curious …

Certain Prefunded Matching Contributions Not Included

As discussed earlier, a contribution is an elective contribution only if the contribution is made after the participant performs the services with respect to which the elective contribution is made (or when the cash or taxable benefit would be currently available, if earlier).[102] An employer contribution also cannot be treated as an employer matching contribution made with respect to an elective contribution if it is contributed before such time.[103] In addition, employer matching contributions made with respect to after-tax employee contributions may not be contributed before the after-tax employee contributions to which they relate. The effect of this rule is to treat any prefunded employer matching contributions as nonelective contributions (e.g., discretionary contributions to the underlying profit-sharing plan) that would have to be allocated in accordance with the terms of the plan pertaining to such contributions, unless an exception applies.

As with elective contributions, a contribution of employer matching contributions is not treated as failing the rule described above merely because contributions for a pay period are occasionally made before the services with respect to that pay period are performed, provided the prefunding is made in order to accommodate bona fide administrative considerations.[104]

Forfeitures that are allocated as employer matching contributions do not fail to satisfy this rule merely because they relate to contributions made before the services were performed.[105] Any forfeitures that are allocated as employer matching contributions are counted in computing an employee's ACR.

Amounts released from an ESOP suspense account that are allocated as employer matching contributions do not fail to satisfy this rule merely because they relate to contributions made before the services were performed.[106] This exception is conditioned

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[102] Treas. Reg. §1.401(k)-1(a)(3)(iii)(C)(1).
[103] Treas. Reg. §1.401(m)-1(a)(2)(iii)(A).
[104] Treas. Reg. §§1.401(k)-1(a)(3)(iii)(C)(2) and 1.401(m)-1(a)(2)(iii)(C).
[105] Treas. Reg. §1.401(m)-1(a)(2)(iii)(B).
[106] Treas. Reg. §1.401(m)-1(a)(2)(iii)(B).

upon the contribution being a required payment due under the loan terms and not being made early with a principal purpose of accelerating deductions.

After-tax Employee Contributions and Matching Contributions Relating to a USERRA-covered Military Service Period are Disregarded

After-tax employee contributions made by a re-employed participant with respect to military service covered by USERRA, pursuant to IRC §414(u), are disregarded in calculating the ACR of the participant for the plan year in which the contributions are made and for any other plan year. Similarly, employer matching contributions made by the employer with respect to make-up elective contributions or make-up after-tax employee contributions made with respect to a USERRA-covered military service period are also disregarded.[107] In other words, the make-up contributions are not counted for the plan year which includes the military service period to which they relate nor to the plan year for which they are actually contributed.

Certain Forfeited Matching Contributions are Disregarded

A plan may provide for the forfeiture of employer matching contributions that are allocated on:

- excess contributions under the ADP test,
- excess aggregate contributions under the ACP test, or
- excess deferrals under IRC §402(g)(2)(A).[108]

Any employer matching contribution that is forfeited in relation to excess contributions or excess deferrals is excluded from the ACR.[109] The forfeiture of a match allocated in relation to an after-tax employer contribution that failed the ACP test will be part of the correction of that failure.

Treatment of Excess Contributions that are Recharacterized as Catch-up Contributions

If a participant is catch-up eligible under IRC §414(v), all or a portion of the participant's elective contributions in excess of the ADP dollar limit must be recharacterized as catch-up contributions (unless the catch-up limit for the year has already been reached).[110] If employer matching contributions have been allocated to such recharacterized catch-up contributions, the plan is permitted to treat the recharacterized catch-up contributions as excess contributions and forfeit the attributable match.[111] If the plan takes this approach, then the match so forfeited would also be disregarded from the ACP test.

In lieu of the forfeiture described in the prior paragraph, the plan may choose to retain the match on excess contributions that are recharacterized as catch-up contributions in the HCE's account. Retention of the match in the HCE's account will not fail to satisfy IRC §401(a)(4). In other words, employer matching contributions on catch-up contributions that exceed the ADP limit are not treated as creating a discriminatory rate of match, even

[107] IRC §414(u)(1)(C) and Treas. Reg. §1.401(m)-2(a)(5)(vi).
[108] IRC §411(a)(3)(G).
[109] Treas. Reg. §1.401(m)-2(a)(5)(v).
[110] Treas. Reg. §1.414(v)-1(d)(2)(iii).
[111] Treas. Reg. §1.414(v)-1(d)(2)(iii) (last sentence).

though the person making such catch-up contributions is an HCE and would have had the match forfeited had the HCE not been catch-up eligible.

Treatment of Excess Contributions from the ADP Test Recharacterized as After-tax Employee Contributions

An HCE's excess contributions under the ADP test that are recharacterized as after-tax employee contributions are included in the ACP test as part of an HCE's contribution amount.[112] Because this will make the ACP test harder to pass, this type of recharacterization is done very rarely.

Inclusion of QNECs in Contribution Amount

If the employer makes QNECs for the plan year, those amounts may be treated as part of the contribution amount for the ACP test. QNECs must be 100 percent vested and subject to the 401(k) distribution restrictions. Any QNECs used in the ACP test may not also be used in the ADP test, and vice versa.

EXAMPLE 2-56. QNECs Used to Boost ACR. Assume the employer makes QNECs equal to 2 percent of IRC §414(s) compensation for all NHCEs. Cindy's employer matching contributions for the plan year equal 1 percent of her IRC §414(s) compensation. She does not make any after-tax employee contributions. Her ACR may be calculated as 3 percent, because the QNECs may be added to the employer matching contributions for purposes of the ACP test.

EXAMPLE 2-57. No Duplication for Testing. Suppose, in the prior example that a portion of the QNECs allocated to Cindy, equal to 1.2 percent of her compensation, was used to boost her ADR under the ADP test. That leaves QNECs equal to only 0.8 percent (i.e., 2% minus 1.2%) of her compensation available for the ACP test, because QNECs used in the ADP test cannot be used again in the ACP test. If the remaining QNECs are used in the ACP test, Cindy's ACR is adjusted to 1.8 percent (the original 1% plus the remaining 0.8% QNEC).

Double-counting Limits When Plan Switches to Prior Year Testing Method

When a plan switches from using the current year testing method in one year (which we will call Plan Year 1) to using the prior year testing method in the next year (which we will call Plan Year 2), the NHCE data from Plan Year 1 is being used twice for testing purposes: once to run the ACP test for Plan Year 1 under the current year testing method, and again to run the ACP test for Plan Year 2 under the prior year testing method. The prior year data may need to be adjusted before the data are used in Plan Year 2 under the prior year testing method. These double-counting limits

[112] Treas. Reg. §1.401(m)-2(a)(4)(ii).

affect the ACP test performed for Plan Year 2 by requiring QNECs to be disregarded if they were used for ADP or ACP testing purposes in Plan Year 1.

IRC §414(s) Compensation

Compensation used to determine ACRs for ACP testing purposes must satisfy a definition of IRC §414(s) compensation.[113] This is the same requirement that applies to ADP testing.

Sample ACR Calculations

EXAMPLE 2-58. 401(m) Arrangement Consists Only of Matching Contributions. A participant's IRC §414(s) compensation for the plan year is $40,000. The participant participates in a 401(k) plan that includes an employer matching contribution formula. The participant defers $2,000 under the 401(k) arrangement. The employer matching contribution is 50 percent of the contribution, or $1,000. There are no after-tax employee contributions under the plan. For ACP purposes, the participant's ACR is $1,000/$40,000, or 2.5 percent if gross compensation is used.

EXAMPLE 2-59. 401(m) Arrangement Consists of After-tax Employee Contributions and Matching Contributions. Assume, in the prior EXAMPLE 2-58, that the plan also permits after-tax employee contributions. The participant contributes $500 as an after-tax employee contribution. The ACR is $1,500/$40,000, or 3.75 percent.

EXAMPLE 2-60. 401(m) Arrangement Consists Only of After-tax Employee Contributions. A profit-sharing plan, which does not contain a 401(k) arrangement, permits after-tax employee contributions. A participant, whose IRC §414(s) compensation is $80,000, makes $2,000 of after-tax employee contributions for the plan year. The 401(m) arrangement consists of the after-tax employee contributions. The ACR for this participant is $2,000/$80,000, or 2.5 percent.

EXAMPLE 2-61. After-tax Employee Contributions are Matched. Suppose the plan in the prior EXAMPLE 2-60 provides a 50 percent employer matching contribution on after-tax employee contributions that do not exceed 4 percent of compensation. The after-tax employee contributions and employer matching contributions constitute a 401(m) arrangement. A participant's IRC §414(s)

[113] Treas. Reg. §1.401(m)-5, Compensation.

compensation for the plan year is $30,000. He makes an after-tax employee contribution of $900 and receives an employer matching contribution allocation of $450. The participant's ACR is $1,350/$30,000, or 4.5 percent.

If You're Curious …

DISPROPORTIONATE MATCHING CONTRIBUTIONS ALLOCATED TO NHCES ARE DISREGARDED FOR ACP TESTING

There is an additional condition on the inclusion in the ACP test of employer matching contributions allocated to NHCEs. Under this rule, employer matching contributions would be disregarded from the ACP test to the extent that they exceed the greatest of:

5 percent of IRC §414(s) compensation;
100 percent of the participant's elective contributions for a year; or
twice the plan's representative matching rate.[114]

Representative Matching Rate

The plan's representative matching rate is the greater of:

the lowest NHCE matching rate among a sampling of eligible NHCEs that equals at least 50 percent of the total eligible NHCEs; or
the lowest NHCE matching rate of any eligible NHCE who is employed by the employer as of the last day of the plan year.

For this purpose, only eligible NHCEs who make elective contributions or after-tax employee contributions for the plan year are taken into account. This is true even though eligible NHCEs who do not make such contributions (and, thus, do not get employer matching contributions) would still be included in the ACP test at a zero percent contribution rate. [Remember, as explained earlier, that an eligible employee for ACP testing purposes includes a participant who would be eligible for employer matching contributions if he or she were to make elective contributions (or after-tax employee contributions, in the case of a plan that matches such contributions).]

Definition of Matching Rate

A participant's matching rate is generally the total amount of employer matching contributions made for such participant divided by the participant's elective contributions.[115] If the plan matches after-tax employee contributions rather than elective contributions, the employer matching contributions are divided by the participant's after-tax employee contributions. If the plan matches both elective contributions and after-tax employee contributions, then the denominator of this fraction is the sum of those contributions for such participant.[116]

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[114] Treas. Reg. §1.401(m)-2(a)(5)(ii).
[115] Treas. Reg. §1.401(m)-2(a)(5)(ii)(C).
[116] Treas. Reg. §1.401(m)-2(a)(5)(ii)(D).

EXAMPLE 2-62. Matching Rate. An employee's elective contributions for a plan year total $1,000. There are no after-tax employee contributions made by the employee. The employer matching contributions made for the employee total $500. The matching rate is 50 percent ($500/$1,000).

If the plan provides for a matching rate that is not the same for all levels of elective contributions (or after-tax employee contributions, if applicable), the participant's rate of match is determined by assuming the participant has deferred 6 percent of compensation. (If employer matching contributions are made in proportion to only after-tax employee contributions or the total of contributions and after-tax employee contributions, it is assumed that the total matchable contributions equal 6 percent of compensation.)[117]

EXAMPLE 2-63. Matching Rate. The plan's matching formula is 100 percent on the first 3 percent deferred and 25 percent of the next 3 percent deferred. A participant whose compensation for the plan year is $20,000 is assumed to defer $1,200 (i.e., 6 percent of $20,000), regardless of how much he or she actually defers. The first 3 percent deferred would be matched at $600. The next 3 percent would be matched at $150, for a total of $750. Thus, the matching rate for this participant is $750 divided by $1,200, or 62.5 percent.

This rule applies only to determine whether the match is disproportionate. It is not used to determine the actual ACR of the participant for purposes of the ACP test. However, if the match turns out to be disproportionate under this rule, the disproportionate amount is disregarded when computing the ACR.

EXAMPLE 2-64. Matching Rate Does Not Exceed 100 Percent. A 401(k) plan provides for employer matching contributions equal to 100 percent of the first 6 percent deferred. The plan has 150 eligible NHCEs, whose deferral rates and matching rates are identified in the table below.

# of NHCEs	Deferral Rate	Match Rate
20	over 6%	100%
5	6%	100%
3	5%	100%
7	4%	100%
45	3%	100%
10	2%	100%
0	1%	100%
60	0%	0%
150		

All of the match would be eligible for inclusion in the ACP test, regardless of the plan's representative matching rate, because the rate does not exceed 100 percent.

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[117] Treas. Reg. §1.401(m)-2(a)(5)(ii)(C).

EXAMPLE 2-65. Targeted Match Formula. A 401(k) plan has a plan year ending December 31. The plan uses the current year testing method. The plan provides for a targeted employer matching contribution formula. Employee A terminated during the plan year, after having earned only

$1,000 of compensation. Employee A contributes at a 5 percent rate, so $50 was withheld from her paycheck and deposited to the plan as elective contributions for the plan year. The employer makes a discretionary match of $100 to Employee A's account, which represents a 200 percent rate of match on her elective contributions. No other employer matching contributions are made for the plan year. The following match rates apply to the six NHCEs who deferred during the plan year:

NHCE	Elective Contributions	Match	Match Rate
A	$50	$100	200%
B	$400	$0	0%
C	$700	$0	0%
D	$1,000	$0	0%
E	$2,000	$0	0%
F	$3,000	$0	0%

The plan could take into account only $50 of A's match in the ACP test, which is the amount of match that would represent a 100 percent match rate. (Note that $50 also represents 5 percent of A's compensation. If 5 percent of compensation actually equaled more than $50, that greater amount could be taken into account even though it exceeds twice the representative match rate.)

Note that the rules regarding disproportionate matching contributions do not prohibit these contributions from being made on behalf of NHCEs. The rules simply prohibit including the disproportionate amounts in the ACP test. Historically, targeted matches were used as the least expensive means of passing the ACP test, so this prohibition has basically eliminated these contributions.

Nonetheless, if an employer has another motivation for giving some NHCEs a higher rate of match than it provides to other NHCEs and the plan so permits, this practice is fine.

2.09: Review of Key Concepts

- What is mandatory disaggregation and how does it apply to 401(k) plans?
- Determine the coverage testing group and the benefiting group for a 401(k) plan.
- Determine the coverage testing group and the benefiting group for a 401(m) plan.
- How may the participants in the testing group and the benefiting group for coverage purposes differ with respect to the 401(k), 401(m) and non-401(k)/non-401(m) portions of the plan?
- What types of contributions may be included in the ADP test?
- What types of contributions may be included in the ACP test?
- Explain the 1.25 test and the 2 percent spread test.
- What is the prior year testing method?

- What is the current year testing method?
- Explain the rules regarding switching testing methods.
- How are participants in the ADP and ACP tests determined?
- Determine an ADR and an ACR.

2.10: For Practice – True or False

1. A plan is always permitted to switch from the current year testing method to the prior year testing method.
2. For coverage testing purposes, the 401(k) part of the plan is tested separately from the 401(m) part of the plan.
3. The 401(m) portion of the plan must satisfy nondiscrimination using the ACP test.
4. Elective deferrals may satisfy nondiscrimination using the general test.
5. Safe harbor 401(k) plans are exempt from IRC §410(b) coverage requirements.
6. After-tax employee contributions are included in the ACP test
7. Designated Roth contributions are included in the ACP test.
8. A plan with no HCEs automatically passes the ADP test.
9. Any participants who terminated during the plan year may be excluded from the 401(k) coverage test.
10. The current year's HCE ADP data is used when using the prior year testing method.

2.11: Sample Test Questions

1. Based on the following information, determine the HCE ADP:

   - None of the HCEs is catch-up eligible.
   - There are no other contributions in the plan.
   - There is no plan-imposed limit on elective deferrals.

HCE	2019 Compensation	2019 Elective Deferrals
A	$200,000	$10,000
B	$80,000	$2,400

   A. 0.00%
   B. 3.00%
   C. 4.00%
   D. 5.00%
   E. 8.00%

2. All of the following statements regarding nondiscrimination testing in a 401(k) plan are TRUE, EXCEPT:

   A. The ADP test can be satisfied by the 1.25 test.
   B. The ACP test can be satisfied by the 2 percent spread test.
   C. The testing data for the NHCE group may be current year data.

D. The testing data for the NHCE group may be prior year data.
E. The testing data for the HCE group may be prior year data.

3. All of the following are excluded in determining the ADP, EXCEPT:

A. Excess deferrals for an HCE
B. Excess deferrals for an NHCE
C. Excess annual additions for an HCE
D. Excess annual additions for an NHCE
E. Catch-up contributions for an HCE

4. Which of the following is/are participants that must be included in the ADP test?

I. An active participant who made no elective deferrals due to a hardship withdrawal restriction
II. An active participant who made no elective deferrals due to IRC §415 limitations
III. A terminated participant who worked 400 hours of service and made no elective deferrals

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

5. All of the following types of contributions may be included in the ACP test, EXCEPT:

A. After-tax employee contributions
B. Make-up employer matching contributions due to USERRA
C. QNECs
D. QMACs
E. Forfeitures allocated as an employer matching contribution

6. All of the following statements regarding IRC §410(b) coverage testing in a 401(k) plan are TRUE, EXCEPT:

A. QMACs that are shifted to the ADP test for nondiscrimination purposes are tested in the 401(m) component of the plan for coverage purposes.
B. QNECs are tested in either the 401(k) or the 401(m) component of the plan for coverage purposes, depending on whether they are included the ADP or ACP test for nondiscrimination purposes.
C. Designated Roth contributions are tested in the 401(k) component of the plan for coverage purposes, even if they are shifted to the ACP test for nondiscrimination purposes.
D. After-tax employee contributions are tested in the 401(m) component of the plan for coverage purposes.
E. Elective deferrals are tested in the 401(k) component of the plan for coverage purposes, even if they are shifted to the ACP test for nondiscrimination purposes.

7. Based on the following information, determine the maximum elective deferral that HCE Y could make that will satisfy the ADP test:

- The NHCE ADP is 3.00%.
- The IRC §401(a)(17) compensation limit in 2019 is $280,000.
- None of the HCEs is catch-up eligible.
- There is no plan-imposed limit on elective deferrals.

HCE	2019 Compensation	2019 Elective Deferrals
X	$500,000	$15,900
Y	$200,000	
Z	$150,000	$4,500

A. $0
B. $6,440
C. $10,200
D. $12,640
E. $18,500

8. Which of the following statements regarding IRC §410(b) coverage testing in a 401(k) plan is/are TRUE?

    I. When testing the 401(k) component, any eligible employee under the 401(k) plan is considered to be benefiting.
    II. When testing the 401(k) component, a participant is treated as not eligible if the right to defer is suspended due to a hardship withdrawal.
    III. An employee who is eligible to receive matching contributions, but chose not to make elective deferrals is considered to be benefiting when testing the 401 (m) component.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

9. Which of the following statements regarding nondiscrimination testing in a 401(k) plan is/are TRUE?

    I. QNECs are tested as nonelective contributions under the 401(a) component for coverage purposes.
    II. QMACs are tested as nonelective contributions under the 401(a) component for coverage purposes.
    III. The general test can be used to show that the 401(m) arrangement satisfies nondiscrimination requirements.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. Which of the following statements regarding the ADP and ACP testing methods is/are TRUE?

    I. After switching from prior year to current year testing, a plan must generally use current year testing for at least three plan years before it can switch back to prior year testing.
    II. A plan may use the prior year testing method for the ACP test while using the current year testing method for the ADP test.
    III. When the plan is using QMACs in the ADP test or shifting elective deferrals into the ACP, the ADP test and the ACP test must use the same testing method.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

See next page for answers to the true/false and sample test questions.

2.12: Solutions to True or False Questions

1. False. A plan can always switch from prior to current year testing, but is subject to restrictions when switching from current year to prior year.
2. True.
3. True.
4. False. The ADP test is the only means available to show that elective deferrals are nondiscriminatory.
5. False. There is no special exception from coverage testing merely because a 401(k) plan is a safe harbor plan.
6. True.
7. False. Designated Roth contributions are elective deferrals and are included in the ADP test.
8. True.
9. False. All participants who were eligible to elect to make elective contributions during the year, whether or not later terminated, are included in the 401(k) coverage test.
10. True.

2.13: Solutions to Sample Test Questions

1. The answer is **C**. The ADR for HCE A is 5.00% ($10,000/$200,000). The ADR for HCE B is 3.00% ($2,400/$80,000). The ADP is the average of the ADRs or 4.00% [(5.00% + 3.00%) / 2].
2. The answer is **E**. The HCE data used for nondiscrimination testing is always current year data, even if the prior year testing method is used.
3. The answer is **A**. Excess deferrals for an HCE are included in determining the HCE's ADR.
4. The answer is **E**. All of the participants listed must be included in the ADP test.
5. The answer is **B**. Make-up contributions due to military service covered by USERRA are not included in the ADP or ACP tests.
6. The answer is **B**. It does not matter if the QNECs are included in the ADP or ACP test. They are tested as nonelective contributions in the 401(a) (i.e., the non-401(k)/non-401(m)) portion of the plan for coverage purposes.
7. The answer is **D**. With an NHCE ADP of 3.00%, the maximum HCE ADP is 5.00%. The 1.25 times test = 3.75% (NHCE ADP of 3% * 1.25) and the 2 percent spread test = 5.00% (the lesser of 3% * 2 = 6% and 3% + 2% = 5%). Since the 5% from the 2 percent spread test is greater than the 3.75% from the 1.25 times test, the maximum HCE ADP is 5%.

8. HCE X's ADR = $15,900 / $280,000 = 5.68%. (In accordance with IRC §401(a)(17), HCE X's compensation for ADP purposes is limited to $280,000.) HCE Z's ADR = $4,500 / $150,000 = 3.00%. To achieve an HCE ADP of 5.00% with three HCEs, the combined ADRs cannot exceed 15.00%. Since 8.68% has been used by HCEs X and Z, that leaves 6.32% for HCE Y. 6.32% of HCE Y's $200,000 compensation equals $12,640.

9. The answer is **C**. If an employee is suspended from deferring under the 401(k) arrangement, the employee is treated as an eligible employee if the employee otherwise would be eligible to defer had the suspension not been in effect.

10. The answer is **A**. QMACs are tested under the 401(m) component for coverage purposes. The ACP test is the only means available to show that a 401(m) arrangement is nondiscriminatory.

11. The answer is **D**. After switching from prior year to current year testing, a plan must generally use current year testing for at least five plan years before it can switch back to prior year testing.

CHAPTER 3:

CORRECTION OF FAILED ADP/ACP TESTS

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3.01: Key Terms

- Allocable earnings
- Alternative method
- Excess aggregate contribution
- Excess contribution
- Gap period
- Leveling method
- Median participant
- Qualified matching contribution (QMAC)
- Qualified nonelective contribution (QNEC)
- Representative contribution rate
- Targeted QNECs

3.02: Introduction

In Chapter 2, we discussed the methods used to perform nondiscrimination testing for a 401(k) and 401(m) arrangement, also known as ADP and ACP testing. What happens, however, when the ADP or ACP testing is failed? The Internal Revenue Code (IRC) and regulations provide for a correction period and for several different methods by which the failure can be fixed. This chapter discusses the correction procedures for ADP and ACP testing failures.

3.03: Correcting Violations of the ADP Test

DESCRIPTION OF AVAILABLE CORRECTION METHODS

If the 401(k) arrangement fails the ADP test, corrective action must be taken to protect the qualified status of the arrangement. There are four correction methods permitted:

11. Distribution of excess contributions;
12. Contributing QNECs;
13. Shifting QMACs into the ADP test; or
14. Recharacterization of excess contributions.[1]

Excess contributions are elective deferrals made on behalf of one or more HCEs that cause the plan to fail ADP testing. In other words, these are the elective deferrals that cause the ADP of the HCEs to exceed permissible limits. The failed test must be corrected within the 12 months following the close of the plan year. For example, if the plan year ends December 31, 2019, the regulatory correction period ends December 31, 2020.

This list of corrective methods does not take into account the possibility that some of the elective deferrals for a plan year that cause the plan to fail the ADP test might be recharacterized as catch-up contributions, pursuant to IRC §414(v). The QNEC and shifting methods are applied before any elective deferrals are recharacterized as catch-up contributions. However, if these are not used, or if they do not fully correct the ADP test failure, the plan would proceed with the distributing of excess contributions or recharacterizing excess contributions as after-tax employee contributions, or a combination of the two. In that case, the catch-up recharacterization rule is applied first, if the plan allows for catch-up contributions. Only excess contributions that cannot be recharacterized

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[1] Treas. Reg. §1.401(k)-2(b).

as catch-up contributions are subject to corrective distribution or recharacterization as after-tax employee contributions.

Distribution of Excess Contributions

Under this correction method, a portion of the elective deferrals (or a portion of other amounts included in the ADP test) is distributed to the HCEs.[2]

Contributing QNECs

Under this correction method, nonelective contributions contributed by the employer are taken into account in the ADP test so that a better testing result is obtained.[3] The nonelective contributions must meet certain vesting and distribution requirements to be treated as QNECs, and must meet certain additional requirements if the QNECs are not allocated as a uniform percentage of compensation. These requirements are discussed later in this chapter.

Shifting QMACs Into ADP Test

QMACs are matching contributions that meet certain vesting and distribution requirements. Normally, matching contributions are tested in the ACP test. However, QMACs may be tested under either the ACP test or the ADP test (or divided between the tests). The shifting of QMACs (or part of the QMACs) into the ADP test can be a technique for correcting a failure of the ADP test or at least reducing the margin of failure.[4]

QMACs may be shifted into the ADP test regardless of whether better testing results are obtained. In other words, this shifting technique may also be used as a means of eliminating the ACP test, where the 401(m) arrangement consists solely of QMACs and all the QMACs are shifted to the ADP test. QMACs must meet certain additional requirements if they are not allocated as a uniform percentage of elective deferrals. These requirements are discussed later in this chapter.

Recharacterization of Excess Contributions as After-Tax Employee Contributions

Under this correction method, excess contributions that would otherwise be distributable under the corrective distribution method are recharacterized as after-tax employee contributions.[5] This results in taxation to the HCEs, as if the amounts were contributed on an after-tax basis. The recharacterized contributions are then tested under the ACP test, as if they were part of the 401(m) arrangement. This method is permitted only if the plan permits after-tax employee contributions.

Combination of Correction Methods Permitted

A failed ADP test may be corrected through a combination of the methods described above. For example, the employer may contribute QNECs to eliminate a part of the violation and distribute excess contributions to complete the correction. Under this approach, the amounts to distribute are

[2] Treas. Reg. §1.401(k)-2(b)(2).
[3] Treas. Reg. §1.401(k)-2(a)(6).
[4] Treas. Reg. §1.401(k)-2(a)(6).
[5] Treas. Reg. §1.401(k)-2(b)(3).

determined after adjusting the actual deferral ratios (ADRs) by including the QNECs. Similarly, the ADP test could be satisfied with a combination of QNECs and QMACs.

Operational Techniques to Facilitate Passing the ADP Test

Some plans authorize the employer to adjust the elective deferral rate of the HCEs during the plan year to prevent the plan from failing the ADP test. Under such authority, the employer reduces the HCEs' rate of elective deferrals on a prospective basis (on a pro rata basis or through some other acceptable means authorized by the document), so that the projected ADP of the eligible HCEs is reduced for the plan year.

When the plan is using the prior year testing method, the ADP limit is known early in the plan year because it is based on the NHCE group ADP from the prior plan year. This makes it easier to use this prospective reduction technique.

Reducing the permissible deferral rate of HCEs is treated as a plan-imposed limit for purposes of the availability to make catch-up contributions only if the limit is contained in the terms of the plan.[6] Also, if the plan allows for catch-up contributions, an HCE who is catch-up eligible is able to exceed the plan-imposed limit by an amount not exceeding the applicable catch-up limit.

PLAN HAS A NONQUALIFIED CODA IF ADP FAILURE NOT CORRECTED ON TIMELY BASIS

A violation of the ADP test must be corrected within the 12-month regulatory correction period. If the correction is not made within that period, the 401(k) arrangement is treated as a nonqualified cash or deferred arrangement (CODA) for the plan year for which the corrective action was not taken on a timely basis and for subsequent plan years in which the excess contributions remain in the plan.[7] Under a nonqualified CODA, the elective contributions made to the plan are includible in the participant's gross income for the taxable year in which they were deferred. The underlying plan is not necessarily disqualified, but the elective contributions under the nonqualified CODA are required to satisfy the general nondiscrimination requirements under IRC §401(a)(4), rather than the ADP test.[8] Failure to pass the general test would disqualify the plan.

EPCRS Available

Through the Employee Plans Compliance Resolution System (EPCRS),[9] the employer may avoid treatment of the 401(k) arrangement as a nonqualified CODA by correcting the ADP failure after the regulatory correction period has passed.

Even though EPCRS is available to fix an ADP failure after the end of the 12-month regulatory correction period, correction within the 12-month period is preferable. The EPCRS programs usually involve more out-of-pocket costs for the employer than the normal regulatory corrections,

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[6] Treas. Reg. §1.414(v)-1(b)(1)(ii).
[7] Treas. Reg. §1.401(k)-1(a)(5).
[8] Treas. Reg. §1.401(k)-1(a)(5)(iv).
[9] Rev. Proc. 2016-51, I.R.B. 2016-42, 466, October 17, 2016.

as some form of QNEC or QMAC is generally required. When corrections are done within the regulatory period, refunds to the HCEs may be the sole source of correction.

3.04: Correcting Violations of the ACP Test

DESCRIPTION OF AVAILABLE CORRECTION METHODS

If the 401(m) arrangement fails the ACP test, corrective action must be taken to protect the qualified status of the plan. There are three correction methods permitted:

15. Distribution or forfeiture of excess aggregate contributions;
16. Contribution of QNECs or QMACs; or
17. Shifting elective deferrals into the ACP test.[10]

The regulatory correction period is the same as for the ADP test – the 12-month period following the close of the plan year being tested.

Excess aggregate contributions are matching contributions or after-tax employee contributions made on behalf of HCEs that cause the plan to fail the ACP test. In other words, these are the contributions that cause the ACP of the HCEs to exceed permissible limits.

Distribution or Forfeiture of Excess Aggregate Contributions

Under this correction method, a portion of the matching contributions and/or after-tax employee contributions (or other amounts included in the ACP test) is distributed to the HCEs if they are vested.[11] Generally, excess aggregate contributions that are not vested are forfeited.

Contributing QNECs or QMACs

Under this correction method, nonelective contributions contributed by the employer are taken into account in the ACP test so that a better testing result is obtained.[12] The nonelective contributions must meet certain vesting and distribution requirements to be treated as QNECs or QMACs. The contributions also must meet certain additional requirements if the QNECs are not allocated as a uniform percentage of compensation or QMACs are not allocated as a uniform percentage of deferrals. These requirements are discussed later in this chapter.

Shifting Elective Deferrals Into ACP Test

The shifting of elective deferrals (or part of the elective deferrals) into the ACP test can be a technique for correcting a failure of the ACP test or at least reducing the margin of failure.[13] Note, however, that when elective deferrals are shifted into the ACP test, the plan must satisfy the ADP test twice:

- First, including all the elective deferrals; and

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[10] Treas. Reg. §1.401(m)-2(b).
[11] Treas. Reg. §1.401(m)-2(b).
[12] Treas. Reg. §1.401(m)-2(a)(6).
[13] Treas. Reg.§1.401(m)-2(a)(6)(ii).

- Then excluding the elective deferrals that are shifted to the ACP test.

Combination of Correction Methods Permitted

The correction may be accomplished through a combination of the correction methods described above. For example, the employer may make QNECs to eliminate a part of the violation and distribute excess aggregation contributions to complete correction. Under this approach, the amounts to distribute are determined after adjusting the ACRs for the QNECs.

Improper Methods of Correcting Excess Aggregate Contributions

The methods described above are the only methods available for correcting an ACP test violation. The regulations identify the following methods as improper methods of correction.[14]

Allocation to Suspense Account

Placement of the excess aggregate contributions in a suspense account for allocation in future years is not permitted. The excess aggregate contributions must be treated as allocated to the HCE and then, if necessary, distributed or forfeited in accordance with the corrective distribution method.

Forfeiture

Forfeiture of vested matching contributions that are excess aggregate contributions (i.e., contributions that cause the plan to fail the ACP test) is not permitted if the sole reason for the forfeiture is that such vested matching contributions are excess aggregate contributions under the ACP test. In other words, vested matching contributions cannot be forfeited merely because they cause the plan to fail the ACP test. To correct a failed ACP test, matching contributions that are excess aggregate contributions must be distributed to the participant if they are vested and may be forfeited only if they are unvested.

Orphan Match

It is important to distinguish matching contributions that are the cause of a failed ACP test (i.e., excess aggregate contributions) from matching contributions that relate to excess contributions (elective deferrals that fail the ADP test) or excess deferrals (elective deferrals in excess of the IRC §401(a)(30) limit). Matching contributions (whether or not vested) must be forfeited if they are allocated based on elective deferrals that are excess contributions or excess deferrals.[15] These matching contributions are often referred to as an "orphan match" or "hanging match." If an orphan match is not forfeited, the HCE would retain matching contributions on impermissible deferrals, which results in discrimination in favor of this HCE.

EXAMPLE 3-1. Forfeiture of Vested Match Associated With Excess Contributions. The plan's matching contribution is 50 percent of the elective deferrals. An HCE defers $4,000 for the plan year and receives a matching

[14] Treas. Reg. §1.401(m)-2(b)(1)(iii).
[15] IRC §411(a)(3)(G).

contribution of $2,000. Because of a violation of the ADP test, $1,000 of the elective deferrals is distributed to the HCEs.

The matching contribution amount allocated with respect to those elective deferrals is $500 (i.e., 50 percent of the distributed elective deferrals). That orphan matching amount must be forfeited by the plan, even if the $500 is vested.

Disregarding the Plan's Allocation Formula

Failure to allocate the matching contributions due the HCEs under the terms of the plan is not a proper method of correcting an ACP violation. In other words, if an HCE is entitled to an allocation of matching contribution of $3,000 under the terms of the plan, that allocation is not permitted to be reduced merely because it will cause the plan to fail the ACP test. The HCE should be allocated the match and then either the excess amount should be distributed or forfeited under the corrective distribution method or another correction method, such as contribution of QNECs, may be used to pass the test.

Operational Techniques to Facilitate Passing the ACP Test

Some plans authorize the employer to adjust the contribution rates of the HCEs prospectively during the year to prevent the plan from failing the ACP test. For example, if the plan permits after-tax employee contributions, the employer might be authorized to reduce the HCEs' rate of after-tax employee contributions prospectively (on a pro rata basis or through some other acceptable means authorized by the document), so that the projected ACP of the eligible HCEs is reduced for the plan year. This is different from the prohibited methods described above, because the plan is not failing to allocate employer contributions due the HCEs nor are contributions already made being forfeited. Instead, the employer is reducing prospective after-tax contributions by the HCEs that would otherwise be included in the ACP test.

Similarly, some plans are designed with a discretionary matching contribution formula, under which the employer can declare a different rate of matching contribution for the HCEs. This lesser rate of discretionary matching contributions for the HCEs produces better ACP testing results. Again, the prohibited methods described above are not being employed with this technique. The employer is not disregarding the plan formula. Instead, the plan formula is designed so that the employer can tailor its rate of matching contribution to produce better testing results.

When the plan is using the prior year testing method, the ACP limit is known early in the plan year because it is based on data from the prior plan year to determine the ACP of the NHCE group. This makes it easier to use the techniques described above.

FAILURE TO MAKE TIMELY CORRECTION DISQUALIFIES PLAN

If the violation of the ACP test is not corrected within the 12-month regulatory correction period, the entire plan is disqualified, because it is treated as failing to satisfy IRC §401(a)(4).[16] If the plan

[16] Treas. Reg. §1.401(m)-2(b)(4)(ii).

terminates during the plan year, correction must be made as soon as administratively feasible after the date of termination, but in no event later than 12 months after the termination date.[17]

The disqualification continues as long as the excess aggregate contributions remain in the plan. Compare this result with the one for failure to correct an ADP violation on a timely basis. In the latter case, the plan itself is not necessarily disqualified. Instead, the CODA created by the 401(k) arrangement is treated as a nonqualified CODA, which results in current taxation of the employees' elective contributions but not necessarily the disqualification of the plan in its entirety.

EPCRS Available

As with late correction of the ADP test, the employer may avoid the disqualification of the plan by correcting the ACP failure through EPCRS even though the regulatory correction period has passed. Even though EPCRS is available to fix an ACP failure after the end of the 12-month regulatory correction period, correction within the 12-month period is preferable.

3.05: Distributing Excess Contributions

EXCESS CONTRIBUTIONS

If this correction method is used, excess contributions (i.e., elective deferrals that fail the ADP test) must be distributed no later than 12 months after the close of the plan year for which testing is being performed.[18] Certain excise taxes apply if the distribution is made more than 2½ months after the end of the tested plan year [or, in the case of a 401(k) plan with an EACA, made more than six months after the end of the tested plan year].

The Leveling Method

The regulations require that the plan administrator use a leveling method to determine which HCEs have excess contributions and the amount of those excess contributions.

The **leveling method** involves a two-step process to determine the amount to be distributed to each HCE who is an eligible employee for the plan year in which the ADP failure occurred.[19]

Step #1: Determine the Total Amount to be Distributed

The first step is to determine the total excess amount to be distributed. This is the amount by which the ADRs of the HCEs would have to be reduced to reach an ADP for the HCEs that will pass the ADP test.[20] To make this calculation, HCEs are listed in descending order of their respective ADRs (not the elective deferral amounts).

It is important to note at the onset that this part of the calculation is used simply to determine the amount of the total distribution to all affected HCEs. The actual amount to be distributed to each

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[17] Treas. Reg. §1.401(k)-1(f)(4)(i) (ADP test correction) and §1.401(m)-1(e)(3)(i) (ACP test correction).
[18] Treas. Reg. §1.401(k)-2(b)(v).
[19] Treas. Reg. §1.401(k)-2(b)(ii) and (iii).
[20] IRC §401(k)(8)(B) and Treas. Reg. §1.401(k)-2(b)(2)(ii).

affected HCE is not determined as part of this step. Even though we will speak in this description of reducing the elective deferrals of a given HCE, that reduction is on paper only at this stage. No amount is actually removed from any HCE's account.

The elective deferrals of the HCE with the highest ADR are reduced first by the smallest amount needed to do one of the following things:

- Cause the ADP of the HCE group to reach a percentage that satisfies the ADP test; or
- Cause the ADR of the affected HCE to be equal to the ADR of the HCE with the next highest ADR.

If the next highest ADR is reached before the ADP test is passed, elective deferrals for both the HCE at that next percentage and the first HCE are then reduced by the smallest amount needed to either satisfy the test or equal the next highest HCE ADR. This process is repeated until the adjusted ADP for the HCE group satisfies the ADP test.

EXAMPLE 3-2. Determining Total Amount to be Refunded. Suppose the ADRs for a plan's three HCEs are as follows:

	Elective Deferral	Compensation	ADR
HCE #1	$12,000	$150,000	8%
HCE #2	$ 9,800	$140,000	7%
HCE #3	$12,600	$210,000	6%

The ADP for the HCEs is 7 percent [(8% + 7% +6%)/3]. The ADP for the NHCEs is 4 percent. The necessary ADP for the HCEs for the ADP test to be passed is 6 percent. To reduce the average of the ADRs for the three HCEs by 1 percent, the reduction to the total of the three individuals' ADRs must be 3 percent.

First, HCE #1's elective deferrals would be reduced until his or her ADR is 7 percent (i.e., the ADR of HCE #2). The reduction is equal to $1,500 (i.e., 1 percent of HCE #1's compensation). Then, the elective deferrals of both HCE #1 and HCE #2 would be reduced until their ADRs equal 6 percent. HCE #1's elective deferrals would be reduced by another 1 percent (i.e., $1,500), and HCE #2's elective deferrals would be reduced by 1 percent ($1,400). The total of the ADRs for the three HCEs is then 18 percent, and the average is the needed 6 percent. The total amount to be refunded is $4,400 ($1,500 + $1,500 + $1,400).

Although the total refund amount is determined by this process, the actual respective refund amounts to each HCE are not determined this way. The actual refund amount for each HCE is determined under Step #2.

Step #2: Apportion Total Amount to be Refunded Among Eligible HCEs

The second step is to allocate the total amount to be refunded among the HCEs. This is done in descending order of their elective deferral amounts.[21] The HCE with the highest elective deferral amount is reduced first until either:

- The total amount to be refunded has been allocated; or
- The next highest HCE dollar amount is reached.

If the next highest dollar amount is reached before the total amount to be refunded is allocated, the HCE at that next dollar amount level is also reduced until the total refund amount is allocated or the next highest HCE dollar amount level is reached. This process is repeated until the total amount to be refunded is allocated.

EXAMPLE 3-3. Allocate the Total Amount to be Refunded. Continuing the calculations from the prior EXAMPLE 3-2, the total amount to be refunded is $4,400.

Align the HCEs in decreasing order of the dollar amount of elective deferrals:

	Elective Deferral	Compensation	ADR
HCE #3	$12,600	$210,000	6%
HCE #1	$12,000	$150,000	8%
HCE #2	$9,800	$140,000	7%

First, the total amount to be distributed is allocated to HCE #3 until his or her total elective deferrals equal those of HCE #1 or until the total amount to be distributed is used up, whichever comes first.

HCE #3's elective deferrals are reduced by $600 to $12,000 (the amount equal to the elective deferrals of HCE #1). The remaining total amount to be distributed is $3,800 ($4,400 minus the $600 already allocated to HCE #3).

The remaining amount to be distributed is allocated equally to HCE #3 and HCE #1 until either their respective elective deferrals are reduced to the same amount as HCE #2 or the distribution amount is completely used up. In this case, the amount allocated to HCE #3 and HCE #1 is $1,900 each (i.e., $3,800 divided by two). This reduces each of their total elective deferrals to $10,100. Because this uses up the total excess contributions to be distributed, no refund amounts are allocated to HCE #2.

The result is as follows:

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[21] IRC §401(k)(8)(C); and Treas. Reg. §1.401(k)-2(b)(2)(iii).

	Elective Deferral	Amount to Distribute	Remaining Deferral
HCE #3	$12,600	($2,500)	$10,100
HCE #1	$12,000	($1,900)	$10,100
HCE #2	$9,800	($0)	$9,800
Total		($4,400)	

If the total amount to be refunded was larger, and HCE #3 and HCE #1 had elective deferrals remaining after the first two allocations equal to those of HCE #2 ($9,800 in this example), any remaining amount to be distributed would be allocated among all three HCEs equally.

Why would the rules be written this way? If only Step #1 were performed, the HCE who would receive a refund would be the HCE with the highest ADR. This usually would be the highest-deferring lowest-paid HCE. For example, suppose that a borderline HCE (e.g., someone earning $120,001) chooses to defer the maximum of $19,000 for 2019. The ADR for that participant would be 15.41 percent. An HCE earning the maximum includible compensation of $275,000, on the other hand, would have an ADR of only 6.73 percent. As a result, the lower-paid HCE would be forced to receive the larger distribution (and would receive a distribution of more than $9,800 before the higher-paid HCE would receive any distribution at all).

The effect of this structure would be that the lower-paid HCEs are prevented from deferring significant amounts. Under the procedure that is actually performed, the elective deferrals by HCEs who must take distributions will be the same dollar amounts. This seems more equitable than punishing a lower-paid HCE.

Deferral Amounts Do Not Include Catch-Up Contributions

The elective deferrals taken into account to determine which HCEs deferred the greatest amount do not include elective deferrals that are catch-up contributions by reason of a statutory limit [e.g., IRC §402(g)] or a plan-imposed limit (e.g., plan provides that elective deferrals for the plan year may not exceed 15 percent of compensation).[22] In other words, the same elective deferrals that are initially disregarded in running the ADP test are also disregarded in determining each HCE's share of the total corrective distribution under this Step #2.

HCEs All at Same Dollar Amount

If the elective deferrals of the HCEs are all at the same dollar amount, then the total correction amount calculated under Step #1 is divided equally among the HCEs in Step #2 of the calculation. For example, suppose the total correction amount determined under Step #1 is $5,000, and there

[22] Treas. Reg. §1.414(v)-1(d)(2)(ii).

are ten HCEs, all of whom have deferred $18,000. The $5,000 total correction amount is divided equally among the ten HCEs (i.e., $500 each).

ADP Test Will Not Actually Pass After Refunds Are Made

Under the leveling method, the percentages of the HCEs are not actually being reduced to the levels that would be needed to pass the ADP test. The percentage reductions are used only in the first step of the process, to determine the total correction amount, but the total correction amount is divided up by dollar amounts of elective deferrals to determine who receives the corrective distributions. If the deferral percentages of the HCEs are recalculated after the distributions are made, the ADP test would still not pass. However, the test is deemed to be passed and the ADP of the HCE group is deemed to have been reduced to the target percentage.[23]

Treatment of Excess Deferrals Under IRC §402(g)

If any HCE has made excess deferrals (i.e., elective deferrals other than catch-up contributions that exceed the IRC §402(g) dollar limit), then the excess deferral is included in the HCE's ADR for ADP testing purposes, even if the excess deferral is distributed by the plan. When applying the two-step leveling method, the total correction amount under Step #1 is determined by including the excess deferral in the ADR of the affected HCE. The total correction amount is then divided up in Step #2 by taking into account the total elective deferral for that HCE (including the HCE's excess deferral).

EXAMPLE 3-4. Treatment of Excess Deferrals in ADP Correction. Jude, an HCE that is not eligible to make catch-up contributions, deferred $21,000 for the 2020 calendar year. Because the dollar limit under IRC §402(g) for 2020 is $19,500, Jude has exceeded the limit by $15000. The plan year is also the calendar year. Jude's 2020 compensation is $150,000.

For ADP testing purposes for the 2020 plan year, Jude's deferral percentage is 14.00 percent ($21,000/$150,000). If the refund method is being used to correct the ADP test failure, the total correction amount under Step #1 of the leveling method is determined by treating Jude's deferral percentage as 14.00 percent, even though $1,500 of Jude's elective deferrals must be refunded under IRC §402(g).

When dividing the total correction amount among the HCEs under Step #2, Jude's elective deferral amount is $21,000. Assuming the second highest elective deferral amount for any other HCE does not exceed the IRC §402(g) limit, Jude will be allocated the first $2,000 of the total correction amount before any other HCEs are allocated a portion of the amount to be refunded.

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[23] Treas. Reg. §1.401(k)-2(b)(2)(ii)(C).

EXAMPLE 3-5. Catch-up Contributions. Suppose in EXAMPLE 3-4 that Jude is a catch-up eligible participant. The catch-up limit for 2020 is $6,500. Catch-up contributions are not subject to the IRC §402(g) dollar limit and are not subject to ADP testing. Therefore, only $19,500 of Jude's elective deferrals would be included in the ADP test, and only those amounts are taken into account in determining Jude's corrective distribution amount if the ADP test is failed. The other $1,500 represents catch-up contributions.

Recharacterizing Distribution Amounts as Catch-Up Contributions

If the plan permits catch-up contributions and an HCE is a catch-up eligible participant, a portion of the HCE's corrective distribution must be recharacterized as a catch-up contribution if the catch-up limit has not yet been reached.

Initial Determination of Catch-up Contributions Made Before ADP Testing

Before running the ADP test, the plan first identifies any catch-up contributions made by the HCE, based on the statutory limits imposed by IRC §402(g) and IRC §415 and any plan-imposed limit on the permissible level of elective deferrals.[24] However, the catch-up contributions identified on that basis might not equal the catch-up limit that is available to the participant under the plan with respect to a particular calendar year. For example, for 2020, a participant may make catch-up contributions to a plan in an amount of $6,500. The initial calculation might determine that the participant has exceeded the statutory or plan-imposed limit by only $3,000. That leaves $3,500 of unused catch-up limit.

Absorbing Unused Catch-up Limit Through ADP Correction Process

If the participant is an HCE, however, some of that unused catch-up limit might be absorbed if the ADP test is failed. This is because IRC §414(v)(3) provides that the making of catch-up contributions shall not cause the plan to fail the ADP test. So, a second determination of catch-up contributions is made after the ADP test is run and it is determined that the plan fails. Any corrective distribution amount assigned to an HCE under the leveling method first must be applied to unused catch-up contributions, to the extent the HCE is eligible to make catch-up contributions and the initial determination of catch-up contributions did not use up the limit for the calendar year

[24] Treas. Reg. §1.414(v)-1(d)(2)(i).

or calendar years included in the plan year.[25] If the excess contributions allocated to the HCE exceed the remaining available catch-up limit, the balance must be distributed.

To the extent that a limit is determined on the basis of a plan year or limitation year that is not a calendar year, the catch-up limit for the calendar year in which the plan year ends is used to determine whether any unused catch-up limit remains.[26]

If the HCE is a catch-up eligible participant and the catch-up limit has not been fully utilized, the HCE's excess contributions under the ADP test must be recharacterized as catch-up contributions up to the remaining catch-up limit. To fail to do so would violate the catch-up rules because the employee would not be given an effective opportunity to make catch-up contributions in excess of the ADP limit.

EXAMPLE 3-6. Calendar Year Plan. A catch-up eligible HCE has compensation for 2020 of $210,000 and he defers $20,000 for calendar year 2020. The IRC §402(g) limit for 2020 is $19,500, and the catch-up limit for 2020 is $6,500. The plan year is also the calendar year.

Only $19,500 is subject to the ADP test, because the remaining $500 is treated as catch-up contributions (i.e., the first $6,500 over the IRC §402(g) limit is treated as a catch-up contribution). It is assumed here that neither the IRC §415 limit nor any plan-imposed limit would prohibit $19,500 of elective deferrals to be contributed to the plan by this HCE.

Because $500 of the HCE's elective contributions are catch-up contributions, $6,000 of the 2020 catch-up limit is unused. The HCE's ADR for ADP testing is 9.29 percent (i.e., $19,500/$210,000).

The ADP test is failed. Suppose the corrective distribution assigned to this HCE under the leveling method is $6,350. The first $6,000 of that corrective distribution (i.e., $6,500 minus the $500 catch-up contribution already used) is recharacterized as catch-up contributions to absorb the HCE's unused catch-up limit. The remaining $350 is distributed as an excess contribution.

EXAMPLE 3-7. Noncalendar Year Plan. A 401(k) plan has a plan year ending June 30. For the year ending June 30, 2020, Saundra, an HCE, has deferred a total of $18,000: $8,000 from July 1 through December 31, 2019, and $10,000 from January 1 through June 30, 2020. Saundra's elective deferrals have not exceeded any plan-imposed limit for the June 30, 2020, plan year. In addition, the IRC §415 limit has not been exceeded for that year.

[25] Treas. Reg. §1.414(v)-1(d)(2)(iii).
[26] Treas. Reg. §1.414(v)-1(c)(3).

The $8,000 of elective deferrals for the first six months of the year did not cause Saundra to exceed the IRC §402(g) limit for 2019. As of June 30, 2020, Saundra has not exceeded the IRC §402(g) limit for 2020 (which is $19,500) because her elective deferrals since January 1, 2020, total only $10,000.

Saundra is a catch-up eligible participant. The ADP test is failed for June 30, 2020, and the employer elects to cure the failure through the corrective distribution method. It is determined that Saundra's elective deferrals for the plan year that exceed $13,700 are excess contributions. The HCE's total deferrals for the plan year are $18,000, and the ADP limit is $13,700, so the remaining $4,300 is subject to distribution.

Because Saundra is a catch-up eligible participant, the entire $4,300 is recharacterized as catch-up contributions. This counts against Saundra's catch-up limit for 2020, because the plan year ends in that calendar year, even though Saundra had not used up any catch-up limit for 2019. The catch-up limit for 2020 is $6,500, so there is still $2,200 left to determine by how much Saundra's elective deferrals for calendar year 2020 may exceed the applicable IRC §402(g) limit of $19,500.

Examples of ADP Test Corrections

EXAMPLE 3-8. No Catch-up Contribution Feature in the Plan. A plan that does not permit catch-up contributions has four HCEs. The compensation, elective deferral amounts and ADRs for the plan year ending December 31, 2017, are as follows.

HCE	IRC §414(s) Compensation	Elective Deferrals	ADR
Hester	$230,000	$18,000	7.83%
Raymond	$150,000	$16,500	11.00%
Lilly	$105,000	$12,200	11.62%
Manuel	$90,000	$9,000	10.00%
ADP = 10.11%			

The ADP for the HCE group is 10.11 percent. The ADP of the NHCEs is 6 percent, so the HCEs are limited by the ADP test to 8 percent. To determine the corrective distributions, the two-step process is applied.

Determining the Total Amount to Distribute Under Step #1

Under Step #1, the total distribution amount is calculated as if the distributions would be based on the ADRs of the HCEs, reducing them in descending order of their respective percentages. Lilly's percentage would be reduced first, then, if necessary, Raymond's percentage, then Manuel's percentage, and finally, if necessary, Hester's percentage.

To reach an average of 8 percent for the HCEs, it would be necessary to reduce the percentages for Raymond, Lilly and Manuel to 8.06 percent. (Technically, Lilly is treated as being reduced first to 11.00 percent, which is Raymond's percentage, and then they both are reduced to 10 percent, which is Manuel's percentage and then all three are reduced down to 8.06 percent, which is the balance needed to meet the targeted ADP). Note that the ADRs for the three HCEs do not need to be reduced all the way to 8 percent because we are averaging in Hester's 7.83%.

- *Raymond.* A reduction for Raymond to 8.06 percent would result in a refund of $4,410.00, because 8.06 percent of Raymond's compensation ($150,000) is $12,090.00, and Raymond's elective deferrals totaled $16,500 ($16,500 – $4, 410.00 = the goal of $12,090.00).
- *Lilly.* A reduction of Lilly to 8.06 percent would result in a refund of $3,737.00, because 8.06 percent of Lilly's compensation ($105,000) is $8,463.00, and Lilly's elective deferrals totaled $12,200. ($12,200 - $3,737.00 = the goal of $8,463.00).
- *Manuel.* A reduction of Manuel to 8.06 percent would result in a refund of $1,746.00, because 8.06 percent of Manuel's compensation ($90,000) is $7,254.00, and Manuel's elective deferrals totaled $9,000.00. ($9,000.00 - $1,746.00 = $7,254.00).

The total of the refunds calculated above is $9,893.00 ($4,410.00 + $3,737.00 + $1,746.00). However, the actual refunds are not made in this proportion, but are determined under Step #2.

Allocating the Total Amount to Be Distributed Under Step #2

Under Step #2 the total correction amount of $9,893.00 is not distributed from the account balances of Raymond, Lilly and Manuel in the proportions determined in Step #1. The total amount to be distributed now must be allocated among the HCEs based on the amount of their elective deferrals.

- The first $1,500.00 of the total correction amount would be allocated to Hester because she has the greatest amount of elective deferrals. This allocation takes her elective deferrals down to $16,500.00 (which equals Raymond's elective deferrals).

- The next $8,393.00 of the total correction amount would be allocated equally to Hester and Raymond (i.e., $4,196.50 each). This allocation takes their elective deferrals down to $12,303.50 each.

Lilly and Manuel are not allocated any of the amount to be distributed because the adjusted deferrals for Hester and Raymond exceed Lilly's total elective deferral of $12,200 and Manuel's total elective deferral of $9,000.00. When the correction is complete, Hester and Raymond would each have $12,303.50 of their 2017 deferrals remaining in the plan. Thus, the leveling method has leveled the elective deferrals of the HCEs to no more than $12,303.50.

Recap of Distribution Calculation

Under Step #1 (determines total amount to be distributed):

- Raymond's refund would be $4,410.00.
- Lilly's refund would be $3,737.00.
- Manual's refund would be $1,746.00.
- Total distribution amount: $9,893.00

Under Step #2 (determines who gets the distributions):

- Hester's distribution is $5,696.50
- Raymond's distribution is $4,196.50.
- Lilly's distribution is $0.00.
- Manuel's distribution is $0.00.

Because of Step #2 of the leveling method, the adjusted HCE ADRs, based on the remaining elective deferrals, do not actually pass the ADP test.

HCE	IRC §414(s) Compensation	Remaining Elective Deferrals	ADR
Hester	$230,000	$12,303.50	5.35%
Raymond	$150,000	$12,303.50	8.20%
Lilly	$105,000	$12,200.00	11.62%
Manuel	$90,000	$9,000.00	10.00%
ADP = 8.79%			

As this table shows, the actual ADP for the HCE group is 8.79 percent after the corrective distributions (not 8 percent, as was the maximum ADP for the HCE group under the testing). Even though this exceeds the 8 percent maximum under the ADP test, the ADP test is deemed to be corrected because the amount returned equaled the amount that would have been distributed if the ADRs of Raymond, Lilly and Manuel had been reduced to 8.06 percent each.

EXAMPLE 3-9. Catch-up Contributions Allowed. Let us assume the same facts as in the prior EXAMPLE 3-8, except that the plan allows for catch-up contributions. Furthermore, assume that, because catch-up is allowed, Hester defers $23,000. There is no plan-imposed limit and no one has exceeded the IRC §415(c) limit, so no portion of elective deferrals is treated as a catch-up contribution by reason of such limits.

HCE	Compen-sation	Age	Elective Deferral	Initial Catch-up	ADP Elective Deferral	Unused Catch-up	ADR
Hester	$230,000	57	$23,000	$5,000	$18,000	$0	7.83%
Raymond	$150,000	53	$16,500	$0	$16,500	$6,000	11.00%
Lilly	$105,000	62	$12,200	$0	$12,200	$6,000	11.62%
Manuel	$90,000	45	$9,000	N/A	$9,000	N/A	10.00%

ADP = 10.11%

Because the plan allows for catch-up contributions, the administrator must subtract from each catch-up eligible HCE's total elective deferrals for the plan year the amount by which such total exceeds the IRC §402(g) for 2017 (i.e., $18,000), but not more than the catch-up limit for 2017 ($6,000).

The Initial Catch-up column shows this adjustment. For Hester, it is $5,000, because she exceeded the IRC §402(g) limit by $5,000. Raymond and Lilly did not exceed the IRC §402(g) limit and Manuel

is not catch-up eligible (i.e., he is under age 50). If Raymond or Lilly had exceeded the IRC §415(c) limit or a plan-imposed limit, there would be additional amounts of their elective deferrals treated as catch-up contributions in this column.

The ADP Elective Deferral column shows the amount of each HCE's elective deferrals that are left after the Initial Catch-up amount is subtracted out. This is the amount of each HCE's elective deferral that is actually included in the ADP test and is reflected in the ADR for each HCE in the last column.

The same adjustment would be made to the NHCEs' percentages to calculate the ADP of the NHCEs if there were catch-up eligible participants whose elective deferrals exceeded the IRC §402(g) limitation. As stated in the prior EXAMPLE 3-8, the ADP of the NHCEs is 6 percent, yielding a maximum ADP for the HCEs of 8 percent. We'll assume that the ADP of the NHCEs is still 6 percent after any such adjustments for catch-up contributions.

After the adjustment for the Initial Catch-up amounts, the ADP Elective Deferrals are the same as the elective deferrals included in the calculation in the prior EXAMPLE 3-8, and Step #1 and Step #2 of the leveling method would produce the same split on excess contributions. However, a portion of the excess contributions is recharacterized as a catch-up contribution. The following table summarizes these calculations.

HCE	ADP Elective Deferral*	Excess Under § IRC 401(k)(8)	Recharacterized Catch-up	Excess Contributions	Remaining Elective Contributions
Hester	$18,000	$5,696.50	$1,000.00	$4,696.50	$13,303.50
Raymond	$16,500	$4,196.50	$4,196.50	$0.00	$16,500.00
Lilly	$12,200	$0.00	$0.00	$0.00	$12,200.00
Manuel	$9,000	$0.00	$0.00	$0.00	$9,000.00
*Reduced by amounts considered to be catch-up contributions prior to ADP test (i.e., $5,000 for Hester).					

Explanation of calculation. The amounts shown as Excess Under §401(k)(8) are the same as the excess contributions shown in the prior EXAMPLE 3-8. However, because the plan allows for catch-up contributions, the maximum amount of elective deferrals permitted under the leveling method, which is $12,303.50, is the ADP Limit for catch-up contribution purposes. Thus, a portion of Hester's and Raymond's excess is

recharacterized as a catch-up contribution, because these participants had an unused catch-up limit for 2017. The HCEs are refunded only the amount by which their excess contributions under the leveling method exceed their unused catch-up limit.

When the dust settles, Hester is left with $18,303.50 of her original total of elective deferrals for the 2017 plan year, which is $6,000 greater (i.e., the catch-up limit for 2017) than the ADP dollar limit of $12,303.50. In other words, because of the ADP test, this HCE was not actually allowed to defer up to the IRC §402(g) limit of $18,000.00, but only up to $12,303.50, which is the ADP dollar limit allowed under the nondiscrimination testing. Through the catch-up rules, she was allowed for 2017 to exceed that dollar limit by another $6,000.00.

Raymond also exceeded the ADP dollar limit, but not by a full $6,000.00, so no portion of his elective deferrals were actually distributed.

Character of Excess Contributions if Designated Roth Contributions Are Made to the Plan

If the 401(k) plan being tested allows employees to designate all or any portion of their elective deferrals as Roth contributions, the excess contributions being distributed may be attributable to designated Roth contributions. A corrective distribution of designated Roth contributions is not a qualified distribution under the Roth rules,[27] so the portion of the distribution attributable to net earnings is subject to taxation.[28]

If an HCE's elective deferrals for a plan year include both pre-tax elective contributions and designated Roth contributions, the regulations allow the plan to permit the HCE to make an election as to which type of contribution is attributable to the excess contributions being refunded.[29] The language in the regulations relating to such election also appear to permit the plan to specify the ordering preference for distributed or recharacterized excess contributions, not giving the HCE an option. For example, the plan may designate that any excess contributions shall be deemed to be designated Roth contributions to the extent that the participant made such contributions during the year, and that pre-tax elective contributions will be distributed or recharacterized only after all designated Roth contributions have been addressed. Designating the character of the refunded deferrals may make administering such refunds easier than permitting the HCEs to determine on an individual basis what type of deferral should be refunded.

Forfeiture of Associated Matching Contributions

If excess contributions that are distributed have been matched, the effect of the distribution of the excess contributions is that the remaining matching contributions are excessive when compared to the remaining elective deferrals.

Treas. Reg. §1.401(a)(4)-4 requires that benefits, rights and features under a plan, including each rate of match, be available on a nondiscriminatory basis. If there are distributions of elective

[27] IRC §402A(d)(2).
[28] IRC §402A(d)(2)(C).
[29] See Prop. Treas. Reg. §1.401(k)-2(b)(1)(ii).

deferrals to correct the ADP test, but no adjustment to the corresponding match, the HCE ends up with a discriminatory rate of match – that is, the matching contributions for the plan year are a higher percentage of the undistributed elective deferrals for the plan year than the rate of match available to the NHCEs. To avoid this result, the plan must forfeit the matching contributions associated with the distributed excess contributions. This forfeiture occurs even if the matching contribution would otherwise be considered to be vested.

EXAMPLE 3-10. Forfeiture of Matching Contribution. Maude is an HCE who deferred $19,000 to her employer's plan for 2020. The plan matches elective deferrals at a rate of 50 percent. Therefore, $8,500 of matching contributions was allocated to Maude's account. If the ADP test fails and Maude must receive a distribution of $5,000 of her elective deferrals, the matching contribution rate is now $8,500/$12,000 or 70.83 percent.

This is discriminatory; that is, an HCE is getting a higher rate of match than any NHCE. As a result, Maude's matching contributions associated with the distributed $5,000 ($2,500) must be forfeited, leaving her with matching contributions equal to 50 percent of the remaining elective deferrals.

3.06: Distributing or Forfeiting Excess Aggregate Contributions

Distributions or forfeitures of the excess aggregate contributions (i.e., matching contributions or after-tax employee contributions that fail the ACP Test) must occur no later than 12 months after the close of the plan year for which testing is performed.[30] Certain excise taxes apply if the correction is made more than 2½ months after the end of the tested plan year [or, in the case of a 401(k) plan with an EACA, made more than six months after the end of the tested plan year].

LEVELING METHOD

The leveling method used to determine excess contributions under the ADP test, as described above, also applies to determine excess aggregate contributions under the ACP test.[31]

Calculation of Amount of Excess Aggregate Contributions to be Distributed

The total amount to distribute to all HCEs is determined under the same two-step process that applies to corrections of an ADP test failure.

EXAMPLE 3-11. Leveling Method to Correct ACP Test Failure. To illustrate, suppose the plan provided for a match equal to 100 percent on the first 4 percent

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[30] Treas. Reg. §1.401(m)-2(b)(v).
[31] Treas. Reg. §1.401(m)-2(b)(2)(ii) and (iii).

deferred. You have the following information about the matching contributions for Shelley, William, Layla and Janet.

HCE	IRC §414(s) Compensation	Matching Contribution	ACR
Shelley	$221,179	$8,847.16	4%
William	$147,453	$5,898.12	4%
Layla	$110,009	$4,400.36	4%
Janet	$90,000	$3,600.00	4%
ACP = 4%			

Suppose the ACP for the NHCE group is only 1.75 percent, resulting in a maximum percentage for the HCE group of 3.5 percent (i.e., two times 1.75 percent, since that is less than adding two percentage points to 1.75 percent). Under the two-step leveling method, the total correction amount is first determined. This is calculated as if we were going to reduce the percentages of the HCEs, in descending order of percentage, until the average reached 3.5 percent. Because all four HCEs have the same contribution percentage, Step #1 would reduce each HCE to 3.5 percent.

This would yield the following distribution amount under Step #1:

Shelley: $8,847.16 − ($221,179 × 3.5%)	=	$1,105.90
William: $5,898.12 − ($147,453 × 3.5%)	=	$737.27
Layla: $4,400.36 − ($110,009 × 3.5%)	=	$550.05
Janet: $3,600 − ($90,000 × 3.5%)	=	$450.00
Total for Step #1:		$2,843.22

Under Step #2, because Shelley's matching contributions total $8,847.16, which exceeds the next highest dollar amount (William's) by $2,949.04, Shelley is assigned the entire $2,843.22 of distribution amount. Had the amount to be distributed exceeded $2,949.04, the next portion would be divided equally between Shelley and William until either the entire distribution amount were used up or the ACPs of Shelley and William were reduced to Layla's level. So, to correct the ACP testing failure, $2,843.22 of matching contributions must be distributed to Shelley.

As the above **EXAMPLE 3-11** illustrates, the leveling method does not actually correct the ACP test. If the contribution percentages were recomputed in the example, based on the matching contributions remaining in the plan after the corrective distribution is completed, the percentages would be as follows.

HCE	IRC §414(s) Compensation	Matching Contribution	ACR
Shelley	$221,179	$6,003.94	2.71%
William	$147,453	$5,898.12	4%
Layla	$110,009	$4,400.36	4%
Janet	$90,000	$3,600.00	4%

ACP = 3.68%

Only Shelley's percentage is reduced because only she receives a distribution of excess aggregate contributions in the amount of $2,843.22. After the reduction, the average of the four percentages is 3.68 percent. As noted above, the average actually needed to correct the ACP violation was 3.5 percent. The test is deemed to be corrected because the amount distributed to Shelley was determined on the basis of the amounts that would have been returned to all four HCEs if their percentages had actually been reduced to 3.5 percent (as determined under Step #1) to obtain an average of 3.5 percent.[32]

If the plan allows for catch-up contributions, and there are matching contributions on the catch-up contributions, those matching contributions are included in the ACP test, and should be treated like any other match when applying the leveling method.

If You're Curious …

Character of the Excess Aggregate Contribution Being Distributed

If the 401(m) arrangement includes only matching contributions, the excess aggregate contribution is a matching contribution. If the 401(m) arrangement includes only after-tax employee contributions, the excess aggregate contribution is an after-tax employee contribution. If the 401(m) arrangement includes both types of contributions, the aggregate contribution may be either type, as determined under the plan provisions.

The characterization of the contribution will affect the tax consequences of the distribution. The portion of the distribution treated as after-tax employee contributions is not taxed at the time of the distribution, because it represents amounts previously taxed to the employee—that is, they were after-tax employee contributions when they were contributed. However, the allocation of earnings on the excess aggregate contribution will be taxable to the participant when distributed. Of course, the distribution of matching contributions and associated earnings is fully taxable.

EXAMPLE 3-12. Apportioning the Distribution of Excess Aggregate Contributions Between Matching Contributions and After-tax Employee Contributions. Terrell's excess aggregate contributions for the plan year equal $1,200. Suppose his total contribution amount for the plan year is $5,000, consisting of $1,000 of after-tax employee contributions and $4,000 of vested matching contributions. Matching contributions are allocated on elective deferrals under the plan's 401(k) arrangement. The plan treats excess aggregate contributions as distributed first from the after-tax employee contributions. Because excess aggregate contributions are distributed first from after-tax contributions, $1,000 of the $1,200 to be distributed to Terrell represents a distribution of his after-tax employee contributions for the plan year, and only $200 represents a distribution of matching contributions. That means $1,000 of the corrective distribution is not taxable because it is a return of basis. Any amount in excess of $1,000 (including

[32] Treas. Reg. §1.401(m)-2(b)(2)(ii)(C).

allocable earnings included as part of the total corrective distribution amount) is includible in Terrell's gross income.

The portion of the corrective distribution that represents after-tax employee contributions is determined without regard to any other after-tax contributions the employee may have in the plan.[33] Under normal basis recovery rules, the employee's entire tax basis in the plan is compared to the value of the account to determine what portion of a distribution is a recovery of basis.

Partially Vested Matching Contributions

If matching contributions treated as excess aggregate contributions are not fully vested, the nonvested portion (including the allocable earnings on that portion) is forfeited instead of distributed.[34] For example, assume the excess aggregate contribution to be distributed to an HCE is $1,000 of matching contributions, plus $100 of allocable earnings, for a total corrective distribution of $1,100. The HCE is 60 percent vested in matching contributions. The distribution amount is $660 (the vested portion of the corrective distribution including earnings) and the forfeiture amount is $440 (the nonvested portion of the corrective distribution).

If You're Curious …

An example in the regulations describes an alternative method of dealing with the corrective distribution, provided the vested portion of the HCE's matching contributions is not less than the amount to be distributed. To illustrate this alternative, assume an HCE's matching contribution account is valued at $25,000, 60 percent of which ($15,000) is vested. The excess aggregate contribution to be distributed to this HCE is $1,000 of matching contributions, plus $100 of allocable earnings, which results in a distribution of $1,100. Under the alternative approach, $1,100 would be distributed to the HCE, because the entire distribution is treated as attributable to the vested portion of the HCE's entire matching contribution account.

When this approach is used, the plan must provide a separate vesting schedule for the nonvested matching contributions, because the amount left in the HCE's account is no longer proportionate to the vesting percentage under the normal schedule. The remaining matching contribution account balance is $23,900. If 60 percent were applied to this account, it would show a remaining vested portion of $14,340. This overstates the HCE's vested amount in the matching contributions account because $1,100 has already been distributed from the vested portion, and the HCE's total vested amount before the distribution was $15,000.[35] Because this complicates the vesting calculation considerably, it is unusual for a plan to include this provision.

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[33] Treas. Reg. §1.401(m)-2(b)(2)(vi)(A).
[34] Treas. Reg. §1.401(m)-2(b)(2)(v).
[35] Treas. Reg. §1.401(m)-2(b)(5), Example 7.

CORRECTIVE DISTRIBUTIONS MUST OCCUR AFTER THE PLAN YEAR ENDS

A corrective distribution must be made after the close of the plan year.[36]

Example 3-13. Corrective Distribution Timing. Monica is an HCE. For the plan year ending December 31, 2019, the plan fails the ADP test. Corrective distributions are made to cure the violation. Monica's excess contribution is $1,000. The allocable earnings total $75. On November 1, 2019, Monica withdraws $3,000 from her elective deferral account under the hardship distribution provisions. The hardship withdrawal may not be counted as a corrective distribution, because it occurred during the plan year of the ADP failure. The plan must distribute $1,075 to Monica during 2020 to correct the ADP violation for 2019.

If the HCE received the entire account balance during the plan year, the portion of the withdrawal equal to the corrective distribution is treated as a distribution of the excess amount for tax purposes.[37] This may occur because the employee terminated employment and was eligible to take distribution during the year, or because the plan terminated and distributions were made before the corrective distribution amounts were determined.

EXAMPLE 3-14. HCE Terminated and Received Distribution. Suppose Monica had terminated employment on September 10, 2019, and received her entire account balance on November 1, 2019. The plan would treat $1,075 of the 2019 withdrawal as a corrective distribution and the remaining amount of the withdrawal as Monica's regular distribution.

If the HCE rolled over the entire distribution, the portion that represents the corrective distribution would have to be included in income and treated as a contribution to the plan that accepted the rollover.

ALLOCABLE EARNINGS INCLUDED IN CORRECTIVE DISTRIBUTIONS

The excess contributions or excess aggregate contributions to be distributed, as determined above, must be adjusted for allocable earnings. Allocable earnings are the net gains or losses for the plan

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[36] Treas. Reg. §1.401(k)-2(b)(2)(v) (ADP correction) and §1.401(m)-2(b)(2)(v) ACP correction).
[37] Treas. Reg. §1.401(k)-2(b)(2)(v) (ADP correction) and §1.401(m)-2(b)(2)(v) ACP correction).

year that are attributed to the excess contributions or excess aggregate contributions. The plan year for this purpose is the plan year for which the ADP test or ACP test is being corrected.

Allocable Earnings for the Plan Year

A plan may use any reasonable method to calculate the allocable earnings for the plan year.[38] The method used must be consistently applied to all corrective distributions made for the plan year, and must reflect the method used by the plan to allocate income to account balances. For example, a plan could determine the actual share of earnings generated by the excess contribution or excess aggregate contribution.

Alternative Formula Provided by Regulations

As an alternative to determining the actual earnings generated by the excess or excess aggregate contribution, the plan may use a formula outlined by the regulations for computing allocable income.

Under the alternative method, the earnings on the excess contributions (i.e., the amounts that caused the plan to fail the ADP testing) are equal to the earnings for the plan year attributable to elective deferrals, multiplied by the following fraction:

$$\frac{\text{excess contributions for the plan year}}{\text{account balance attributable to elective deferrals}}$$

If amounts other than elective deferrals (e.g., QNECs) are included in the ADP test, references in the formula to “elective deferrals” include such other amounts.[39]

Under the alternative method, the earnings on the excess aggregate contributions (i.e., the amounts that caused the plan to fail the ACP testing) are equal to the earnings for the plan year attributable to matching contributions and after-tax employee contributions, multiplied by the following fraction:

$$\frac{\text{excess aggregate contributions for the plan year}}{\begin{array}{c}\text{account balance attributable to matching}\\ \text{contributions and after-tax employee contributions}\end{array}}$$

If amounts other than matching contributions and after-tax employee contributions (e.g., QNECs) are included in the ACP test, references in the formula to matching and after-tax employee contributions include such other amounts.[40]

If there are elective deferrals, matching contributions, after-tax employee contributions or other amounts included in the applicable test that are made for the plan year, such amounts must be included in the above formulas, even if the contributions are transmitted to the plan after the close of the plan year.[41]

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[38] Treas. Reg. §1.401(k)-2(b)(2)(iv)(B) (ADP correction) and Treas. Reg. §1.401(m)-(b)(2)(iv)(B) (ACP correction).
[39] Treas. Reg. §1.401(k)-2(b)(2)(iv)(C).
[40] Treas. Reg. §1.401(m)-2(b)(2)(iv)(C).
[41] Treas. Reg. §1.401(k)-2(b)(2)(iv)(C) (ADP correction) and §1.401(m)-(b)(2)(iv)(C) (ACP correction).

Net Loss

If the allocable earnings are a net loss, the amount distributed will be less than the excess amount. The HCE includes in income only the actual amount distributed (to the extent taxable). No income tax loss is recognized by the HCE.

EXAMPLE 3-15. Earnings on Excess Contributions or Excess Aggregate Contributions are a Loss. Mona's excess contribution under the ADP test is $2,000. The allocable earnings on the contribution result in a net loss of 10 percent. The amount to be distributed is $1,800 ($2,000 less the 10 percent loss of $200). The amount recognized in income is $1,800. No tax loss is taken by Mona because she did not have to recognize the actual excess contribution amount ($2,000) in income.

TAX TREATMENT OF CORRECTIVE DISTRIBUTIONS

The taxable portion of the amount distributed is includible in the HCE's gross income.

Corrective Distributions Under ADP Test

If all elective deferrals being distributed are pre-tax elective contributions, the corrective distribution under the ADP test is always fully taxable because amounts distributed to correct an ADP test violation are attributable to pre-tax amounts [e.g., pre-tax elective contributions under the 401(k) arrangement, plus the earnings thereon]. However, if all or a portion of the excess contributions being distributed are designated Roth contributions, all or a portion of the corrective distribution is not taxable because it is a return of designated Roth contributions.

A corrective distribution under the ACP test might not be fully taxable. For example, after-tax employee contributions distributed as part of the excess aggregate contributions under the ACP test represent basis for tax purposes and are not includible in income. The taxable year of inclusion for a corrective distribution depends on when the distribution occurs.

Taxation of Distributions of Excess Contributions

Corrective distributions made with reference to ADP failures are taxable in the taxable year of the employee in which distributed.[42]

EXAMPLE 3-16. Taxation of Corrective Distribution. A 401(k) plan has a plan year ending December 31. The plan fails the ADP test for the 2019 plan year. The taxable portion of any corrective distribution made at any time during the regulatory correction period (January 1 to December 31, 2020), is includible in the employee's income in 2020.

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[42] IRC §4979(f)(2).

Distribution of Excess Aggregate Contributions Under the ACP Test

Taxation of Distributions of Excess Aggregate Contributions

Corrective distributions of vested matching contributions made with reference to ACP failures are taxable in the taxable year of the employee in which distributed.[43]

EXAMPLE 3-17. Taxation of Corrective ACP Distribution. A 401(k) plan has a plan year ending December 31. The plan fails the ACP test for the 2019 plan year. The taxable portion of any corrective distribution of vested matching contributions made at any time during the regulatory correction period (January 1 to December 31, 2020), is includible in the employee's income in 2020.

Excise Tax on Employer

If corrective distributions (excess contributions and excess aggregate contributions) are not made within a certain period after the close of the plan year for which the ADP or ACP test is failed, the employer (not the HCE) is liable for an excise tax under IRC §4979.

The corrective distributions must be made no later than 2½ months after the close of the plan year in order to avoid the excise tax. A plan with an EACA is allowed to make ADP/ACP refunds up to six months after the close of the plan year to avoid the excise tax. The same rule applies if excess aggregate contributions attributable to nonvested matching contributions are forfeited.

The excise tax is equal to 10 percent of the amount of the excess contribution (determined before the adjustment for allocable earnings), in the case of a corrective distribution under the ADP test, or 10 percent of the amount of the excess aggregate contribution (determined before adjustment for allocable earnings), in the case of a corrective distribution under the ACP test.

The amount of the excise tax is not affected by the tax consequences of the corrective distribution on the employee receiving the distribution. Thus, the fact that a corrective distribution of excess aggregate contribution might consist in whole or in part of after-tax employee contributions, which are not includible in the employee's gross income, does not reduce the amount of the employer's tax liability on the excess aggregate contributions being distributed more than 2½ months after the close of the plan year.

EXAMPLE 3-18. Calculation of Excise Tax on Amounts Distributed or Forfeited More than 2½ Months After the Plan Year End. A plan with a plan year ending December 31, 2019, that is not an EACA, makes corrective distributions on May 2, 2020, which is more than 2½ months after the close of the plan year. The distributions are made to three HCEs in the following amounts.

[43] IRC §4979(f)(2).

Employee	Matching	After-Tax Employee	Earnings	Total Amount Distributed
HCE #1	$1,200	$0	$100	$1,300
HCE #2	$300	$700	$60	$1,060
HCE #3	$1,100	$500	$125	$1,725
Totals	$2,600	$1,200	$285	$4,085

The excise tax applies to the total amount of matching contributions ($2,600) and after-tax contributions ($1,200) being distributed before the adjustment for earnings ($285). Thus, the excise tax is calculated as follows: 10% x ($2,600 + $1,200), for a total of $380. The 10 percent tax applies to the $1,200 of after-tax employee contributions being returned, even though that portion of an HCE's distribution is not includible in gross income.

There is no exception created under IRC §4979 with respect to excess contributions that are designated Roth contributions, even though no tax deferral has occurred with respect to such contributions. As a result, the employer calculates its excise tax on the amount of the excess contributions being distributed after the 2½-month date (6-month date for EACAs), regardless of whether such contributions are pre-tax elective contributions or designated Roth contributions.

The employer pays the excise tax by filing Form 5330. The due date for payment is the last day of the 15th month following the close of the plan year.[44] By postponing payment of the tax for 15 months, an employer is able to weigh other options to correct the ADP violation (e.g., contribution of QNECs) during the 12-month correction period that may avoid having to distribute the excess contribution and incurring an excise tax.

What If the 2½-month Date Falls on a Weekend or Holiday?

The regulations do not address whether the 2½-month period is extended if it ends on a weekend or holiday. For example, suppose that March 15th is a Saturday. That would be the 2½-month date for correcting ADP violations and ACP violations for a plan year ending on the previous December 31. The IRS has concluded that, where an act is not in connection with the determination, collection or refund of taxes, any extension for a weekend or holiday would have to be expressly granted in the particular statutory provision that applies or by regulation.[45] If the IRS position is correct, a corrective distribution made on Monday, March 17 for the plan year ending on the prior December 31 would be treated as made after the 2½-month period, resulting in taxation to the employee and an excise tax on the employer.

Taxation of Allocable Earnings on Distribution

The allocable earnings distributed with the excess contributions under the ADP test or with the excess aggregate contributions under the ACP test are taxed in the same year as the excess amount is taxed – that is, the year in which the amount is distributed. As previously stated, the excise tax

[44] Treas. Reg. §54.4979-1(a)(3).
[45] Rev. Rul. 83-116.

is equal to 10 percent of the amount of the excess contribution (determined before the adjustment for allocable earnings).

Form 1099-R Used to Report Distribution

The IRS Form 1099-R is used to report corrective distributions. The form for the calendar year of the distribution must be used.[46]

EXAMPLE 3-19. Form 1099-R. A distribution occurring February 1, 2020, to correct a violation of the ADP test for the plan year ending December 31, 2019, is reported on the 2020 Form 1099-R.

Distribution code "8" is used to reflect that the amount distributed represents a payment of excess contributions or excess aggregate contributions.

If any portion of an ADP corrective distribution is attributable to designated Roth contributions, the amount of the designated Roth contributions must be reported in the appropriate box of the Form 1099-R to show such amount is not taxable, since designated Roth contributions are made on an after-tax basis. Also note that distributions attributable to designated Roth contributions are reported separately from distributions attributable to other contributions under the plan. Thus, if a corrective distribution under the ADP test consists partly of designated Roth contributions and partly of pre-tax elective contributions, two Forms 1099-R would be required.

If a portion of an ACP corrective distribution includes after-tax employee contributions, that portion must be included in the appropriate box of the Form 1099-R to show it is not taxable.

No Premature Distribution Penalty

The 10 percent penalty tax under IRC §72(t) for distributions prior to age 59½ is not applicable to corrective distributions.[47]

Not an Eligible Rollover Distribution

Corrective distributions are not eligible rollover distributions under IRC §402(c).[48] Therefore, the 20 percent mandatory withholding for federal income tax purposes does not apply. The withholding rules for distributions that are not eligible rollover distributions do apply.[49] These are

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[46] See the instructions to Form 1099-R.
[47] IRC §401(k)(8)(D).
[48] Treas. Reg. §1.402(c)-2, A-4.
[49] IRS Notice 87-77, 1987-2 C.B. 385.

the rules applicable to nonperiodic distributions that are not eligible for rollover—10 percent withholding unless the recipient of the distribution waives withholding by filing Form W-4P.

No Consents Required for Corrective Distributions

The consent rules under IRC §411(a)(11) and IRC §417 do not apply to corrective distributions.[50] Thus, the consent of the employee is not required to make a corrective distribution, even if the employee's vested interest exceeds $5,000. In addition, the consent of the employee's spouse is not required, even if the plan is subject to QJSA requirements.

Not Part of Minimum Distribution

The corrective distribution does not count toward satisfying the minimum distribution requirement under IRC §401(a) (9).[51] Therefore, if the HCE receiving the corrective distribution has also passed the applicable required beginning date under §401(a)(9) (i.e., age 70½ or, for individuals who do not own more than 5 percent of the plan sponsor, termination of employment, if later), an additional amount equal to the required distribution for the calendar year will have to be distributed.

If You're Curious …

If the plan distributes only part of the corrective distribution to an HCE, that portion is treated as a pro rata distribution of the total excess amount and the allocable earnings on that excess amount.[52]

EXAMPLE 3-20. Partial Corrective Distribution. On March 1, a plan distributes $1,340 to Cory, representing an excess contribution under the ADP test of $1,250 and allocable earnings of $90. It is later determined that the excess contribution should have been $1,400 with allocable earnings of $115, for a total corrective distribution of $1,515.

Because $1,340 has already been distributed, the plan distributes another $175 to Cory. The second distribution occurs on May 15, which is not within the first 2½ months of the correction period, because the plan year to which the distributions relate is the plan year ending on the prior December 31.

To determine the proper tax consequences, the $1,340 distributed on March 1 is treated as a pro rata share of the excess contribution and the allocable earnings that should have been distributed. Thus, $1,400/$1,515 x $1,340, or $1,238, is treated as the excess contribution portion and $102 is treated as the allocable earnings portion.

When the remaining $175 is distributed on May 15, the excess contribution portion is treated as $162 (i.e., $1,400 total excess contribution minus the $1,238 excess contribution distributed on March 1) and the allocable earnings portion is $13. This is

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[50] Treas. Reg. §1.401(k)-2(b)(2)(vii)(A) (ADP test correction) and §1.401(m)-(b)(2)(vii)(A) (ACP test correction).
[51] Treas. Reg. §1.401(k)-2(b)(2)(vii)(C) (ADP correction) and §1.401(m)-(b)(2)(vii)(C) (ACP correction).
[52] as. Reg. §1.401(k)-2(b)(2)(vii)(D) (ADP correction) and §1.401(m)-(b)(2)(vii)(D) (ACP correction).

important for purposes of the employer's excise tax under IRC §4974. The excise tax is 10% x $162, or $16.20, because it is imposed on the excess contribution portion of the distribution that occurs after the first 2½ months of the correction period.

The entire amount distributed is taxed in the year of distribution.

EXAMPLE 3-21. Timely Distribution of Excess Contribution or Excess Aggregate Contribution Without Earnings is a Partial Correction. The corrective distributions for the HCEs under a plan's ADP test have been determined as follows: $1,000 to Linda, $875 to Sima and $420 to Edgar, for a total of $2,295. The plan year ends December 31. On the March 15 following the close of the plan year, the plan disburses $2,295 to the three HCEs before calculating allocable earnings.

It is later determined that the allocable earnings are $90 for Linda, $60 for Sima and $25 for Edgar. These amounts are distributed to the respective individuals on June 1. The employer wants to treat the June 1 distributions as consisting solely of allocable earnings, and treat the excess contributions as fully distributed on March 15 so the 10 percent excise tax will not apply. This is not correct.

The March 15 distributions are treated as partial corrections, and the distributions represent a pro rata portion of the excess contributions and allocable earnings. For example, Linda's $1,000 distribution on March 15 is treated as $917 of excess contributions and $83 of allocable earnings, determined as follows: $1,000/$1,090 x $1,000 = $917 pro rata share of excess contributions. That means $83 of the June 1 distribution to Linda represents the excess contribution portion and the 10 percent excise tax is applied on that amount. A similar calculation is made for Sima and Edgar.

Distributing Too Much

Suppose the plan distributes more than is required to correct the ADP test or ACP test. An overpayment is an operational violation of the terms of the plan and potentially is a disqualifying event. The plan should take reasonable steps to get repayment of the overpayment. The HCE could remit the excess payment back to the plan or might work out an arrangement to have the overpayment withheld from his or her next paycheck. Relief under the IRS' EPCRS (discussed at the beginning of this chapter) is available.

3.07: Recharacterizing Excess Contributions

A variation of the corrective distribution method is to recharacterize the excess contributions under the ADP test as after-tax employee contributions. Because these contributions are made on an

after-tax basis, the excess contributions that are recharacterized must be reported in income as if they were distributed to the employee.[53]

Excess contributions under the recharacterization method are determined in the same manner as under the corrective distribution method. Therefore, the leveling method is used to determine the amount that is recharacterized for each eligible HCE.

The recharacterized contributions are taxed under the same rules as corrective distributions made in the first 2½ months of the correction period.[54] The recharacterized contributions are taxed for the taxable year of the individual in which falls the date that is 2½ months after the close of the plan year.

The affected HCEs must be notified by the plan administrator of the recharacterization and the tax consequences. The notice must be given within the first 2½ months of the correction period.[55] The tax liability is reported on Form 1099-R as if the recharacterized amount were distributed.[56]

The plan document must permit after-tax employee contributions if the recharacterization method is used.[57] The amount of the recharacterized contributions, in combination with the after-tax employee contributions actually made by the HCE for the plan year, may not exceed the maximum amount of after-tax employee contributions permitted by the plan (disregarding any limitation that might be imposed by the ACP test).

The plan may require or permit an HCE to elect whether the excess contribution should be distributed or recharacterized.[58]

Recharacterized contributions are treated as after-tax employee contributions for purposes of the ACP test. If inclusion in the ACP test causes the plan to fail that test, these contributions may be distributed anyway. For all other purposes under the IRC, the recharacterized contributions are still treated as elective deferrals.[59] Thus, the recharacterized contributions remain subject to the distribution restrictions that apply to elective deferrals under IRC §401(k)(2) and (10).

The rules for recharacterization are the same regardless of whether the plan uses the current year testing method or the prior year testing method. Although a plan using the prior year testing method uses prior year data for the NHCEs to run the ADP test, the current year data is always used for the HCEs and recharacterization will apply only to the HCEs. When determining how much of the HCEs' elective deferrals need to be recharacterized as after-tax employee contributions, the ADRs for the prior year's NHCE group will be used to run the ADP test if the prior year testing method is being used.

If the excess contributions are attributable to elective deferrals that have been designated as Roth contributions, it is not clear whether they will be eligible for recharacterization as after-tax employee contributions. If they are, however, then the recharacterization would not trigger

[53] Treas. Reg. §1.401(k)-2(b)(3).
[54] Treas. Reg. §1.401(k)-2(b)(3)(iii).
[55] Treas. Reg. §1.401(k)-2(b)(3)(iii)(A).
[56] IRS Notice 89-32, 1989-1 C.B. 671.
[57] Treas. Reg. §1.401(k)-2(b)(3)(iii)(B).
[58] Treas. Reg. §1.401(k)-2(b)(1)(ii).
[59] Treas. Reg. §1.401(k)-2(b)(3)(iii)(C).

taxation, because the designated Roth contributions are already contributed on an after-tax basis. However, the recharacterization would remove such contributions (including attributable net earnings) from the designated Roth account, and subject them to the normal tax rules of IRC §72 upon their later withdrawal from the plan, not to the special tax rules that apply to designated Roth accounts under IRC §402A(d).

3.08: Contributing Qualified Nonelective Contributions (QNECs)

QNECs may be treated as elective deferral amounts in the calculation of the ADRs under the ADP test, or as matching contribution amounts in the calculation of the ACRs under the ACP test.[60] The contribution of QNECs can be a method of correcting a violation of the ADP test or ACP test if the contributions are used to "boost" the percentages of the eligible NHCEs included in the applicable test.

Obviously, an employer will have to weigh the economics of making QNECs over other correction methods. QNECs represent an out-of-pocket cost to the employer that will increase the retirement plan contribution (and the numerator of the ADR) for the employees who receive the allocation of the QNECs. Other correction methods, such as making corrective distributions to the HCEs, do not involve such out-of-pocket contribution costs.

If a plan is failing both the ADP test and the ACP test, the employer may contribute QNECs to pass (or reduce the failure margin of) both tests. However, the same QNECs may not be used in both tests.

DEFINITION OF QNECS

QNECs are contributions made by the employer that satisfy the vesting, distribution and nondiscrimination requirements described below.[61]

Vesting Requirement

QNECs must be 100 percent vested when allocated to a participant's account, regardless of the employee's length of service. An employer nonelective contribution may not be reclassified after its allocation to be a QNEC, because it will not necessarily have been fully vested when made. Furthermore, prior to 2017 the IRS took the position that forfeitures may not be used to fund a QNEC, because forfeitures are the unvested portion of participants' accounts. Therefore, they were not fully vested when contributed.[62] However, this position changed with the release of final

[60] IRC §401(k)(3)(D) and IRC §401(m)(3) (last paragraph).
[61] Treas. Reg. §1.401(k)-6 and §1.401(m)-5.
[62] See the IRS' Listing for Required Modifications (LRMs) for Cash or Deferred Arrangements (http://www.irs.gov/pub/irs-tege/ coda_lrm1011.pdf)

regulations in 2018. Therefore, if the plan document states that the forfeitures can be used to fund QNECs, it is allowable.

Distribution Restrictions

Distribution of QNECs must be subject to the same restrictions that apply to elective deferrals under a 401(k) arrangement. However, prior to the 2019 plan year, QNECs were not eligible for hardship withdrawal, even if elective deferrals may be distributed for hardship.[63] This was true, regardless of whether the QNECs are used for ADP testing or for ACP testing. Effective with the 2019 plan year, the plan may allow QNECs to be distributed for hardship withdrawals.

Nondiscrimination Test Applies to Nonelective Contributions, Including QNECs

The contributions made by an employer, other than matching contributions, are known as nonelective contributions, even if made under a discretionary contribution formula. The total nonelective contributions made by the employer, including the QNECs, must satisfy the nondiscrimination requirements of IRC §401(a)(4). In addition, the nondiscrimination requirements of IRC §401(a)(4) also must be satisfied taking into account only those nonelective contributions not used in ADP or ACP testing.[64] Therefore, IRC §401(a)(4) must be addressed twice:

- once with all nonelective contributions; and
- once after the QNECs used in the ADP or ACP test have been removed.

EXAMPLE 3-22. Nondiscrimination Requirements. Assume the employer makes QNECs for all employees, including HCEs, equaling 3 percent of IRC §414(s) compensation. There are no other nonelective contributions made for the plan year. The employer wants to use only the QNECs allocated for NHCEs in the ADP test. This will fail the nondiscrimination requirements under IRC §401(a)(4) because, after disregarding the QNECs used in the ADP test, the only nonelective contributions remaining are the QNECs allocated to the HCEs. These amounts will not satisfy the nondiscrimination requirements of IRC §401(a)(4) when they are tested after the QNECs to NHCEs are carved out.

USING QNECS TO CORRECT ADP TESTING FAILURE

Prior Year Testing Method and QNECs Used for ADP or ACP Testing

The IRC §401(a)(4) nondiscrimination test must be applied to QNECs and other nonelective contributions that are allocated for the current plan year. However, if the plan is using the prior year testing method for ADP or ACP testing purposes, the QNECs allocated to the NHCEs for a

[63] Treas. Reg. §1.401(k)-1(d)(3)(ii).
[64] Treas. Reg. §1.401(k)-2(a)(6)(ii) and §1.401(m)-2(a)(6)(iii).

particular plan year will be included in the ADP or ACP test for the next plan year, when the NHCE data are used for testing purposes. For example, a QNEC contributed to a calendar year plan in 2018 will be part of the 2018 ADP for the NHCEs. However, the 2018 ADP testing will use the 2017 ADP for the NHCEs. Therefore, there is a one-year delay in the impact of the QNECs contributed on the nondiscrimination testing.

Regardless of the plan year for which the QNECs are included for ADP testing, all QNECs allocated for a plan year are taken into account to satisfy the IRC §401(a)(4) nondiscrimination testing requirements for such year.[65] Therefore, the QNECs may be includible in the nondiscrimination testing on nonelective contributions in a different year than they are included in the nondiscrimination testing for the 401(k), or nondiscrimination testing on nonelective contributions in a different year than they are included in the nondiscrimination testing for the 401(k) or 401(m) arrangement.

Same QNECs May Not Be Used for Both ADP and ACP Tests

QNECs used in the ACP test may not be used in the ADP test.[66] Similarly, QNECs used in the ADP test may not be used in the ACP test.[67]

EXAMPLE 3-23. QNECs in ADP Test. An employer makes QNECs equal to 3 percent of IRC §414(s) compensation for all eligible NHCEs. The employer does not make any other nonelective contributions for the plan year. All the QNECs are used in the ADP test. The employer may not use any of the QNECs in the ACP test, because they were used in the ADP test.

EXAMPLE 3-24. Remaining QNECs Used in ACP Test. Assume, in the prior EXAMPLE 3-23, that QNECs equaling 1 percent of compensation are used in the ADP test. The remaining QNECs (2 percent of compensation) are available for use in the ACP test.

QNECs May Be Contributed to Separate Plan

An employer may contribute QNECs to a plan that is separate from the plan that contains the 401(k) or 401(m) arrangement. However, the separate plan must have the same plan year as the plan that includes the 401(k) arrangement, in the case of QNECs used for the ADP test, or the plan that includes the 401(m) arrangement, in the case of QNECs used for the ACP test.[68] Although

[65] Treas. Reg. §1.401(k)-2(a)(6)(ii) and §1.401(m)-2(a)(6)(iii).
[66] Treas. Reg. §1.401(k)-2(a)(6)(vi).
[67] Treas. Reg. §1.401(m)-2(a)(6)(vi).
[68] Treas. Reg. §1.401(k)-2(a)(6)(iii) and §1.401(m)-2(a)(6)(iv).

this option is available, most employers contribute QNECs to the same plan that includes the 401(k) or 401(m) arrangement.

QNECs Must Be Contributed Within 12 Months After Close of Plan Year

To be counted in the ADP test or ACP test for a plan year, QNECs must be contributed no later than 12 months after the close of the plan year for which they are allocated.[69] Usually, the employer will make the contribution sooner (i.e., the due date of its tax return for the year for which the QNECs are allocated) because it wants to deduct the contribution for the year of allocation.

If a plan is using the prior year testing method for the ADP test, QNECs allocated to the NHCEs in the prior year must be made no later than 12 months after the close of that prior year. Thus, the 12-month contribution period for the QNECs ends on the last day of the current plan year being tested, not the last day of the 12-month correction period that follows the current plan year.

EXAMPLE 3-25. QNECs and Prior Year Testing. The prior year testing method is being used to run the ADP test for the plan year ending December 31, 2020. That means the 2019 plan year data (i.e., data from the prior plan year) is being used to calculate the ADP of the NHCE group. In this case, to boost the prior year percentage for the NHCEs by including QNECs to produce a higher ADP test limit for the HCEs for the 2020 plan year, the QNECs must be contributed for the NHCEs no later than 12 months after the close of the 2019 plan year – that is, by December 31, 2020. If the ADP test for 2020 is being done after the plan year end, when all data is known and final, it is too late to make QNECs that will affect the NHCE accounts for the 2020 ADP test. Therefore, a plan using the prior year testing method must make QNECs based on an estimated test performed before the end of the year being tested if they are to have any effect on the ADP or ACP tests for that year.

If the plan is using the current year testing method to calculate the ADP or ACP of the NHCE group, then the 12-month contribution rule runs from the end of the plan year being tested, so that QNECs can be contributed during the 12-month regulatory correction period that follows the close of the current plan year.

EXAMPLE 3-26. QNECs and Current Year Testing. Suppose a plan is using the current year testing method to determine the ADP test limit on the HCEs for the 2020 plan year. The ADP of the NHCE group is determined with reference to the ADRs of the eligible NHCEs for the current plan year (i.e., 2020). A final determination of that ADP will not be made until after the close of the 2020 plan year (i.e., after December 31, 2020). The 12-month period for making QNECs for eligible NHCEs for the 2020 plan year ends December 31, 2021 (i.e., 12 months after the close of the current plan year), which also coincides with the end of the

[69] Treas. Reg. §1.401(k)-2(a)(6)(i) and §1.401(m)-2(a)(6)(i).

12-month regulatory correction period for curing any failure of the ADP test for the 2020 plan year. The employer can wait until the ADP test is run on the elective deferrals to determine if it wants to make QNECs to boost the ADP of the NHCEs for the 2020 plan year.

If You're Curious …

IRC §415 Issue Relating to the Timing of Contributions of QNECs. Although QNECs can be contributed up to 12 months after the close of the plan year for which they are allocated, they are annual additions for that prior year only if they are contributed no later than 30 days after the due date for filing the employer's tax return for its taxable year in which the prior year ends.[70] If the contributions are made after that date, they are treated as annual additions for the current year, even though they are allocated for the prior year.

EXAMPLE 3-27. QNECs and IRC §415. If QNECs were made on July 15, 2020, and allocated for the 2019 plan year, the QNECs would be treated as annual additions for 2020, unless the July 15, 2020, contribution date falls within the 30-day period for IRC §415 described above for the 2019 plan year.

Therefore, assuming no matching contributions, the QNECs allocated to an employee for the 2019 plan year could not exceed the lesser of 100 percent of the employee's IRC §415 compensation for the 2020 plan year or the dollar limit in effect for the 2020 plan year.

If the plan has a limitation year that is different from the plan year, note that the 30-day period for IRC §415 is actually measured with reference to the taxable year that ends in the limitation year for which the allocation date falls. The allocation date for QNECs is usually the last day of the plan year for which they are contributed.

If the ADP test or ACP test is not corrected by the end of the 12-month regulatory correction period, the IRS will permit late contributions of QNECs or QMACs under the EPCRS program.

QNEC Allocations

The QNECs must be allocated under a definite allocation formula, as required for all contributions to a profit-sharing plan.[71] The employer cannot pick and choose which participants will receive an allocation of QNECs. A typical plan design is for QNECs to be allocated to all eligible participants

[70] Treas. Reg. §1.415-6(b)(7)(ii).
[71] Treas. Reg. §1.401-1(b)(1)(ii).

who are NHCEs. By limiting the allocation to NHCEs, the QNECs raise the ADRs or ACRs of only the NHCEs and passing the test is made easier.

The allocation formula usually is pro rata based on compensation and all eligible NHCEs receive a uniform allocation rate. As an alternative, the formula in the plan may provide a uniform dollar amount for each eligible NHCE, or may be tailored to provide QNECs to a limited group of NHCEs that may reduce the amount of QNECs necessary to pass the test. However, the resulting QNECs cannot be disproportionate, as such term is defined in the regulations.

The allocation of QNECs also may be conditioned on an NHCE's completion of a service requirement, such as a minimum number of hours of service for the plan year (e.g., 1,000 hours) and/or the requirement to be employed by the employer on the last day of the plan year.

EXAMPLE 3-28. Uniform Allocation to eligible NHCEs. The ADP of the HCEs is 6.23 percent and the ADP of the NHCEs is 2.97 percent. These percentages are based only on the elective deferrals made by the eligible participants. Rather than making corrective distributions, the employer elects to make QNECs.

QNECs are allocated on a pro rata basis to all eligible NHCEs. If all NHCEs in the group receive an allocation of QNECs, the amount the employer must contribute is a percentage of compensation that, when added to the NHCEs' ADP of 2.97 percent, will enable the plan to pass the ADP test. The 2 percent spread test would be satisfied if the ADP for the NHCE group is raised to 4.23 percent.

The difference between the necessary 4.23 percent and the current ADP 2.97 percent is 1.26 percent. The employer contributes 1.26 percent of compensation for the eligible NHCEs in the form of QNECs, and the ADP test is satisfied.

If the prior year testing method is being used in this example, then the QNECs must be allocated to the eligible NHCEs for the prior plan year and must be contributed no later than 12 months after the close of that prior year.

EXAMPLE 3-29. QNECs and Prior Year Testing. The current plan year being tested is the plan year ending December 31, 2020, and the prior year testing method is being used. The 2.97 percent for the NHCE group would be from the 2019 plan year. The 1.26 percent of QNECs would have to be contributed for the eligible NHCEs in the 2019 plan year, and would have to be contributed within 12 months after the close of that prior plan year (that is, by December 31, 2020, if the plan year is the calendar year). The employees that receive the allocation of the QNECs would be based on the QNEC allocation formula in effect for the 2019 plan year and the NHCEs in the 2019 plan year who met the QNEC allocation conditions for that year.

EXAMPLE 3-30. QNECS and Current Year Testing. The plan uses the current year testing method to determine the ADP of the NHCEs. Now the 2.97 percent from the 2019 plan year is not taken into account. Instead, the ADP of the NHCE group has to be calculated on the basis of the deferral percentages of the NHCEs for the 2020 plan year.

Assume that the ADP of the NHCEs for the 2020 plan year is 3.4 percent. Now the ADP would only have to be raised by 0.83 percent to reach the desired percentage of 4.23 percent. The QNECs would be contributed for the 2020 NHCE group, and would have to be contributed within 12 months after the close of the 2020 plan year (that is, by December 31, 2021, if the plan year is the calendar year). In this case, which employees receive the QNEC allocation would be based on the QNEC allocation formula in effect for the 2020 plan year.

EXAMPLE 3-31. QNECs Also Contributed for Use in ACP Test. Let us return to EXAMPLE 3-28 above. There, a uniform allocation of QNECs, equal to 1.26 percent of each eligible NHCE's compensation, was contributed. This raised the ADP of the NHCEs to 4.23 percent, producing an ADP limit under the 2 percent spread test of 6.23 percent. Because the ADP of the HCEs is exactly 6.23 percent, the ADP test is passed.

Suppose there is also an ACP test because there are matching contributions allocated on the elective deferrals. The testing results are as follows: the ACP of the NHCEs is 2.1 percent and the ACP of the HCEs is 4.5 percent. To pass the 2 percent spread test, the ACP of the NHCEs would need to be raised to 2.5 percent.

The employer may contribute additional QNECs to raise the ACP of the NHCEs. The additional QNECs would equal 0.4 percent of the compensation of those eligible NHCEs.

Thus, the total QNECs under this example and EXAMPLE 3-28 above equals 1.66 percent of compensation of the eligible NHCEs. (Actually, only the employees who are eligible for both ADP and ACP purposes would receive a total QNEC of 1.66 percent. If some employees are eligible only for ADP testing purposes, those employees would receive only the 1.26 percent QNEC needed to boost the ADP of the NHCE group.) A portion of the QNECs, representing 1.26 percent of compensation, is included in the ADP test, to raise the ADP of the NHCEs to 4.23 percent. The remainder of the QNECs, representing 0.4 percent of compensation, is included in the ACP test, to raise the ACP of the NHCEs to 2.5 percent, as illustrated in this example.

Administrative Discretion in Using QNECs in the Tests

Although QNECs must be allocated under a definite allocation formula provided in the plan, the decision of whether to include QNECs in the ADP test or ACP test and which employees' QNECs are included in their ADRs can be left to administrative discretion, so long as the nondiscrimination requirements are satisfied.

QNECs May Not Be Conditioned on Whether the Participant Defers Under 401(k) Arrangement

QNECs may not be contributed only for participants who deferred under the 401(k) arrangement. Only matching contributions can be allocated on the basis of whether a participant has deferred.[72] Note that matching contributions may be discretionary and, if they satisfy the definition of qualified matching contributions (QMACs), they may be used to help pass the ADP test. Thus, if the plan gives the employer discretion over the amount of QMACs allocated with respect to elective deferrals, the employer would have the flexibility to make a contribution that will help pass the ADP test but is allocated only to participants who defer under the 401(k) arrangement.

HCEs and QNEC Allocations

There is nothing in the law that precludes QNECs for HCEs, but the employer needs to consider the impact on testing. If QNECs are allocated to the HCEs, the QNECs raise the ADRs or ACRs of that group, making it harder to pass the applicable test. Usually a larger amount of QNECs to NHCEs will be needed to pass testing if the QNECs are also being allocated to the HCEs. Sometimes an employer wants to make QNECs for the HCEs because the employer is not making any other nonelective contributions for the plan year and does not want to "leave out" the HCEs. If this is the employer's motivation, remember that the plan's contributions and allocation formulas for QNECs must state that HCEs share in the allocation.

QNECS INCLUDIBLE IN ADP AND ACP TESTING

IRC §§401(k) and 401(m) regulations significantly limit the inclusion of targeted QNECs (e.g., bottom up QNECs) or QNECs allocated on a per capita basis (i.e., QNECs that are allocated to participants in a uniform dollar amount) in the ADP test or ACP test by adding a condition for such inclusion. Under this condition, disproportionate QNECs, as defined by the regulations, are disregarded for testing purposes.[73] This rule does not preclude the plan from allocating disproportionate QNECs, but rather limits the extent to which such contributions may be used in ADP or ACP testing.

As a practical matter, however, employers are unlikely to contribute QNECs in amounts greater than what can be used in the ADP or ACP test. In fact, many employers who previously made QNECs under methods that would result in disproportionate QNECs under these rules have stopped making QNECs altogether and simply use the corrective distribution method to cure

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[72] IRC §401(k)(4)(A) (known as the "contingent benefit rule").
[73] Treas. Reg. §1.401(k)-2(a)(6)(iv) and §1.401(m)-2(a)(6)(v).

failures of the ADP or ACP test. As will be discussed below in the "If You're Curious" section, targeted QNECs of up to 5 percent of compensation may be allocated to participants' accounts and used in the ADP testing without concern about these limits.

If You're Curious …

Disproportionate QNECs for ADP Testing Purposes

Under the regulations, QNECs allocated to a participant are not considered disproportionate and, thus, are eligible for inclusion in the ADP test, only to the extent they do not exceed the greater of:

a. 5 percent of compensation; or
b. Twice the plan's representative contribution rate.

Because this is a calculation that determines the greater of two numbers, QNECs of at least 5 percent may be allocated to any participant, regardless of the plan's representative contribution rate, and the contribution will not be considered to be disproportionate. But a greater percentage would be allowed only if the representative contribution rate exceeds 2½ percent (i.e., so that twice such percentage would exceed 5 percent).

The plan's **representative contribution** rate is the greater of:

a. The lowest NHCE contribution rate, taking into account a sampling of eligible NHCEs that equals at least half of the total eligible NHCEs; or
b. The lowest NHCE contribution rate of any eligible NHCE who is employed by the employer as of the last day of the plan year.

For purposes of alternative (1), any sampling of eligible NHCEs that constitutes at least half of the total eligible NHCE group may be used. To get the most cost effective QNEC, the administrator would rank eligible NHCEs in descending order of contribution rates and use the rate for the median participant—that is, the participant who is in the middle of the group.

EXAMPLE 3-32. Median Participant. If there are 15 eligible NHCEs, at least eight NHCEs would need to be in the sampling, because 50 percent of 15 is 7.5; therefore, seven NHCEs would be less than half the total NHCEs. The contribution rate of the eighth lowest participant would be the representative contribution rate.

A participant's contribution rate is the sum of:

1. All QNECs (whether or not included in the ADP test), other than QNECs that will be included in the ACP test; and
2. Any QMACs included in the ADP test for the plan year, divided by the participant's compensation.

Because these calculations are made with reference only to the NHCEs, the applicable plan year for determining whether QNECs are disproportionate is the current plan year, if the plan uses the current year testing method, or the prior plan year, if the plan uses the prior year testing method.

The eligible NHCEs for the applicable plan year, and QNECs and QMACs allocated to such eligible NHCEs, are taken into account.

EXAMPLE 3-33. 5 Percent QNEC. A 401(k) plan has a plan year ending December 31. For the 2018 plan year, there are six eligible NHCEs. The plan uses the current year testing method. The following QNECs are allocated to the six NHCEs:

Employee	QNEC rate
A	5%
B	0%
C	0%
D	0%
E	0%
F	0%

There are no QMACs included in the ADP test. None of the QNECs are to be used in the ACP test. The plan may increase Employee A's ADR by the entire amount of QNECs (i.e., the entire QNEC may be included in the testing), because 5 percent or less is deemed not to be disproportionate.

If the plan uses the prior year testing method, the NHCEs and their QNECs would be determined for the 2019 plan year (i.e., the prior plan year with respect to the 2020 plan year).

EXAMPLE 3-34. 10 Percent QNEC for One Participant. Suppose, in the prior example, that Employee A's QNEC rate is 10 percent, rather than 5 percent. The plan would still be able to count only 5 percent of Employee A's QNEC, because anything above 5 percent is disproportionate. The lowest NHCE allocation rate with respect to a sampling of at least half of the eligible NHCEs (i.e., at least three NHCEs) is zero percent, yielding a representative contribution rate of zero percent (i.e., twice zero is still zero).

EXAMPLE 3-35. High Turnover. Suppose, in the prior **EXAMPLE 3-34**, that, although Employee A's QNEC rate is 10 percent, all of the other five NHCEs are no longer employed by the employer as of the last day of the plan year. Now, Employee A's entire amount of QNECs would be eligible for inclusion in the ADP test, because, of the eligible NHCEs who are employed by the employer as of the last day of the plan year (i.e., just Employee A), the lowest contribution rate is 10 percent. Note that coverage testing under IRC §410(b) also must be satisfied with respect to all nonelective contributions, including QNECs. If the QNEC in this **EXAMPLE 3-35** is the only nonelective contribution allocated, then coverage is no problem because the only recipient of the QNEC is an NHCE. However, if the five NHCEs who terminated get no nonelective contributions, but one or more HCEs under the plan do, there may be coverage testing issues here.

EXAMPLE 3-36. More than One Participant Receives an Allocation of QNECs. Let us change the facts one more time. Suppose the QNECs allocated to the six NHCEs are as follows:

Employee	QNEC rate
A	10%
B	5%
C	5%
D	0%
E	0%
F	0%

Now Employee A's entire amount of QNEC may be included in the ADP test. A sampling of eligible NHCEs who represent at least half of the total group consists of Employees A, B and C. The lowest contribution rate among that group is 5 percent, so twice that rate (i.e., 10 percent) is not considered disproportionate.

Plans that provide for an allocation of QNECs on a uniform basis as a percentage of compensation, either to all eligible NHCEs, or to a group that represents at least half of the eligible NHCEs, would not be negatively affected by this disproportionate QNEC rule, because the highest QNEC allocation rate would never fail the test described above. Even if such a plan had a last-day employment requirement for QNECs, these regulations would not have a negative effect, because the representative contribution rate may be determined with reference only to the contribution rates of those eligible NHCEs who are employed by the employer as of the last day of the plan year.

A plan that provides a uniform dollar amount allocation of QNECs could be negatively affected by this new rule because the contribution rate is expressed as a percentage of compensation.

EXAMPLE 3-37. Uniform Dollar Amount Allocation. A 401(k) plan has a plan year ending December 31. For the plan year being tested, there are six eligible NHCEs. The plan uses the current year testing method. The following QNECs are allocated to the six NHCEs:

NHCE	Compensation	QNEC Amount	QNEC Rate
A	$1,000	$500	50.00%
B	$3,000	$500	16.67%
C	$15,000	$500	3.33%
D	$20,000	$500	2.50%
E	$25,000	$500	2.00%
F	$30,000	$500	1.67%

There are no QMACs included in the ADP test. No QNECs are to be used in the ACP test. The representative contribution rate in this example is 3.33 percent if we treat NHCEs A, B, and C as the sampling of NHCEs who represent at least half of all eligible NHCEs. Within that group of three individuals, NHCE C's contribution rate of 3.33 percent is the lowest. Twice that rate is only 6.66 percent. Thus, of the QNECs allocated to NHCEs A and B, an amount not exceeding 6.66 percent of each employee's compensation may be taken into account for ADP testing. For NHCE A, that would be

only $66.60 and for B, only $199.80. The total QNECs for NHCEs C, D, E, and F would be eligible for inclusion because they do not exceed the plan's representative contribution rate.

Davis-Bacon Contributions Subject to Higher Limit

Certain employers enter into construction contracts with the Federal government or the District of Columbia that are governed by the Davis-Bacon Act. This Act controls, among other things, the level of the workers' compensation for purposes of the contractual work, and ensures that it is equal to the current "prevailing wage," which is measured with reference to how much is made by similarly situated workers in that geographic area. Often, these types of contracts also require contributions to a defined contribution plan of a given amount. QNECs that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act or similar legislation can be taken into account to the extent such contributions do not exceed 10 percent of an NHCE's compensation, regardless of the limits described above.[74] However, the QNECs attributable to Davis-Bacon employees still would be counted to determine whether QNECs for non-Davis-Bacon employees are disproportionate.

Disproportionate QNECs for ACP Testing Purposes

Similar rules to those discussed above would apply to the inclusion of QNECs in the ACP test. Thus, QNECs allocated to a participant would be eligible for inclusion in the ACP test only to the extent they do not exceed the greater of:

a. 5 percent of compensation, or
b. twice the plan's representative contribution rate.

In addition, the representative contribution rate would be based on a sampling of eligible NHCEs who represent at least half of the total number of NHCEs, and the lowest contribution rate for eligible NHCEs employed by the employer on the last day of the plan year could be substituted for the lowest rate among the 50 percent group. However, the definition of contribution rate is slightly different. In the definition for ADP testing purposes, QNECs used in the ACP test were disregarded. In the definition for ACP testing purposes, QNECs used in the ADP test would be disregarded. This is consistent with the rule that states that the same dollars of QNECs may not be used in both tests.

5 percent QNEC Could be Contributed for ADP Testing
and ACP Testing Without Violating Either Disproportionate Test

Because the includible QNECs are calculated separately for ADP and ACP testing purposes, an allocation of QNECs equal to 5 percent of compensation could be allocated to each NHCE participant and included in each test (10 percent total), without having to determine the plan's representative contribution rate.

QNECs that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act or similar legislation can be taken into account to the extent such contributions do not exceed 10 percent of an NHCE's compensation,

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[74] Treas. Reg. §1.401(k)-2(a)(6)(iv)(D).

regardless of the limits described above.[75] This 10 percent rule for Davis-Bacon contributions is separate from the 10 percent rule for the ADP test.

Thus, QNECs made in connection with the Davis-Bacon Act could be up to 20 percent for an NHCE, with 10 percent used in the ADP test and 10 percent used in the ACP test. However, the QNECs attributable to Davis-Bacon would still be counted to determine whether non-Davis-Bacon QNECs are disproportionate.

EXAMPLE 3-38. QNECs in ADP and ACP Test. A 401(k) plan has a plan year ending December 31. For the plan year being tested, there are six eligible NHCEs. The plan uses the current year testing method. The following QNECs are allocated to the six NHCEs:

Employee	QNEC rate
A	10%
B	0%
C	0%
D	0%
E	0%
F	0%

There are no QMACs included in the ADP test. The plan would not be able to include Employee A's entire amount of QNECs in just the ADP test or just the ACP test, because 10 percent would exceed the plan's representative contribution rate, which is zero percent.

However, the plan could include Employee A's QNECs in the amount of 5 percent in the ADP test and also include Employee A's QNECs in the amount of 5 percent in the ACP test. In each case, the amount included in the applicable test does not exceed 5 percent of compensation, so it is not disproportionate, and the same QNECs are not included in both tests.

3.09: Shifting QMACs to the ADP Test

Under certain circumstances, QMACs may be shifted from the ACP test (where matching contributions normally are tested) to the ADP test, where they can be used to help the ADP test to be satisfied. One of the shifting techniques is to include all or a portion of the QMACs in the ADP test rather than in the ACP test.[76] Although the regulation cites the use of QMACs in the ADP test as a means of correcting a failure of the test, the inclusion of QMACs in the ADP is not limited to only those circumstances when a failure of the ADP test is being corrected through such inclusion. The regulations allow plans to include QMACs in the ADP test regardless of whether the QMACs are needed to pass the ADP test. Thus, some administrators will include all QMACs in the ADP test simply as a means of simplifying testing; that is, if all matching contributions made under a 401(k) plan are QMACs, and after-tax employee contributions are not permitted under the plan,

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[75] Treas. Reg. §1.401(m)-2(a)(6)(v)(D).
[76] Treas. Reg. §1.401(k)-1(f)(1)(I).

shifting the QMACs to the ADP test eliminates the ACP test entirely. This is because after the QMACs are shifted, there are no contributions left to be tested under the ACP test.

Although this testing technique is referred to as shifting QMACs from the ACP test to the ADP test, this does not imply that the ADP test must first be run without the QMACs. The administrator may initially run the ADP test including some or all of the QMACs, without first determining whether the plan would fail the ADP test without the QMACs. Nonetheless, if any QMACs are included in the ADP test, the plan is said to have shifted the QMACs to the ADP test because, unless the administrator elects to include them in the ADP test, the default test for the QMACs is the ACP test, just like for any other type of matching contributions.

It is possible that excess contributions under the ADP test might be recharacterized as catch-up contributions if any of the HCEs who are catch-up eligible participants have not used up the full catch-up limit for the year involved. The plan may not apply the recharacterization rule first, and then determine how it wants to shift QMACs to produce different testing results. All testing must be completed, including the shifting of QMACs, if desired, before determining whether there are any remaining excess contributions that would be distributable but are eligible instead for recharacterization as catch-up contributions.

DEFINITION OF QMACS

All or a portion of the QMACs may be included in the ADRs.[77] QMACs are matching contributions that satisfy the vesting and distribution requirements described below.

Vesting Requirement

QMACs must be 100 percent vested when allocated to a participant's account, regardless of the employee's length of service. If matching contributions are subject to a vesting schedule, they must be tested under the ACP test and cannot be characterized as QMACs for purposes of the ADP test, even those matching contributions made for a participant who is 100 percent vested under the schedule.

Distribution Restrictions

Distribution of QMACs must be limited under the same restrictions that apply to the elective deferrals under the 401(k) arrangement. However, prior to the 2019 plan year, QMACs were not eligible for hardship withdrawal, even if elective deferrals may be distributed for hardship.[78]

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[77] Treas. Reg. §1.401(k)-2(a)(6) and §1.401(k)-6, Qualified matching contributions, and §1.401(m)-2(a)(5)(iii).
[78] Treas. Reg. §1.401(k)-1(d)(3)(ii).

Effective with the 2019 plan year, the plan has the option to allow QMACs to be distributed for hardship.

USING QMACS TO CORRECT ADP TESTING FAILURE

Excluded From ACP Test if Used in ADP Test

The QMACs used in the ADP test must be excluded from the ACP test.[79] Any QMACs not used in the ADP test must be included in the ACP test for nondiscrimination testing purposes. Whether to include QMACs in the ADP test, the amount of QMACs to include in the ADP test and which participants' QMACs are included in their ACRs may be left to administrative discretion.

Disproportionate QMACs for ADP Testing Purposes

The IRC §§401(k) and 401(m) regulations prohibit the shifting of QMACs to the ADP test if they would be disregarded from the ACP test because they are disproportionate.[80] Whether QMACs are disproportionate is tested by looking at the matching contributions as a whole, not just the matching contributions being shifted or not being shifted to the ADP test.

Remember that the proportionality rule is effective for plan years beginning on or after January 1, 2006.[81]

Not All QMACs Must Be Shifted

A portion of QMACs may be shifted for all eligible participants, for only eligible NHCEs, or for only certain participants (HCE or NHCE), as arbitrarily determined by the plan administrator. For example, the administrator may choose to shift only QMACs that do not exceed 1 percent of each eligible participant’s compensation. Alternatively, the administrator may choose to shift only part of the QMACs that are allocated to all of the eligible NHCEs or only to certain eligible NHCEs.

Examples of Using QMACs in the ADP Test

EXAMPLE 3-39. Plan Using Current Year Testing Method. A 401(k) plan provides for a 100 percent matching contribution on the first 3 percent deferred. Matching contributions are not subject to a vesting schedule, but instead are 100 percent vested at the time of contribution. The matching contributions may be distributed only after separation from service, death, disability or attainment of age 59½. Therefore, all the matching contributions are QMACs. Note that, if the matching contributions were subject to the vesting schedule, the matching contributions would not be QMACs and the employer would not have the option of including any portion of the matching contributions in the ADP test, as shown below.

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[79] Treas. Reg. §1.401(m)-2(a)(5)(iii).
[80] Treas. Reg. §1.401(k)-2(a)(6)(v).
[81] Treas. Reg. §§1.401(k)-1(g)(1) and 1.401(m)-1(d)(1).

The ADP test is not satisfied because the ADP of the HCEs is 7.24 percent and the ADP of the NHCEs is 4.33 percent. The ADP of the HCEs is more than two percentage points higher than the ADP of the NHCEs and is more than 1.25 times the ADP of the NHCEs. However, the ACP test is satisfied, because the ACP of the HCEs (3.00 percent) is not more than 1.25 times the ACP of the NHCEs (2.50 percent).

What testing options are available to the employer? One option is to combine the matching contributions with the elective deferrals, and run only the ADP test, since all the matching contributions are QMACs. Another option is to combine only a portion of the matching contributions with the deferrals, and run the ACP test with respect to the rest of the matching contributions. QMACs do not have to be moved to the ADP test, and the employer may elect to use only a portion of the QMACs in the ADP test.

If the plan allows for catch-up contributions, the deferrals reflected in the third column would not reflect any of the catch-up contributions (i.e., elective deferrals that exceed an otherwise applicable limit, such as the IRC §402(g) limit, the IRC §415(c) limit, or a plan-imposed limit). However, if catch-up contributions are matched, those matching contributions would be included in the matching contribution column.

Furthermore, the elective deferrals made by the HCEs that are included in the ADP test would not be subject to recharacterization as catch-up contributions, until the plan proceeds with corrective distributions to correct a failed ADP test. If QMACs will be shifted, as shown below, that testing technique will be done first. If the QMACs testing technique causes the plan to pass, then no elective deferrals that are included in the ADP test will be recharacterized as catch-up contributions.[82]

EXAMPLE 3-40. Option #1. Combine All Matches with All Deferrals and Run Only the ADP Test. Suppose all the QMACs are shifted to the ADP test, leaving no ACP test. This would generate the following testing results.

Employee	Compensation	Deferrals	Match	Combined	Adjusted ADP
HCEs					
Ilene	$200,000	$11,000	$6,000	$17,000	8.50%
Donna	$98,000	$8,800	$2,940	$11,740	11.98%
Adjusted ADP = 10.24%					
NHCEs					
Gene	$50,000	$4,000	$1,500	$5,500	11.00%
Michelle	$40,000	$2,600	$1,200	$3,800	9.50%
Romi	$30,000	$1,500	$900	$2,400	8.00%

[82] See, preamble to the final IRC §414(v) regulations published on July 8, 2003. 68 .R. 40511.

Kathy	$25,000	$875	$750	$1,625	6.50%
Jim	$20,000	$0	$0	$0	0.00%
Ralph	$20,000	$600	$600	$1,200	6.00%
Adjusted ADP = 6.83%					

Under this approach, the ADP of the HCEs is still more than two percentage points greater than ADP of the NHCEs: 10.24% - 6.83% = 3.41%, and is more than 1.25 times the ADP of the NHCEs: 6.83% x 1.25 = 8.54%. The corrective distribution required would be the amount necessary to reduce the ADP of the HCEs to 8.83%. This would result in a reduction of the ADP by 1.41 percent.

If the matching contributions had been left in the ACP test, the ADP of the HCEs would have to be reduced from 7.24 percent to 6.33 percent, requiring a reduction of 0.91 percent. So, Option #1 does not eliminate the ADP failure, and, in fact, increases the amount needed to be refunded!

If the plan administrator combined the elective deferrals and QMACs and ran a single ADP test, as shown in the above EXAMPLE 3-40, and the plan allows for catch-up contributions, the catch-up recharacterization rule[83] would apply to the excess contributions calculated for Ilene and Donna (to the extent they have not used up the catch-up limit for the current year with respect to elective deferrals already carved out of the ADP test). The QMACs would not be subject to recharacterization as catch-up contributions.

EXAMPLE 3-41. Option #2. Move Only a Portion of Match to ADP Test, and Test the Rest under ACP Test. Suppose QMACs for each NHCE equal to 1.1 percent of the NHCE's compensation, are shifted to the ADP test. You would have the following result.

(1) Employe e	(2) Deferral s	(3) Shifted QMACs	(4) Combine d	(5) Adjusted ADR	(6) Non-shifted QMACs	(7) Adjusted ACR
Gene	$4,000	$550	$4,550	9.10%	$950	1.90%
Michelle	$2,600	$440	$3,040	7.60%	$760	1.90%
Romi	$1,500	$330	$1,830	6.10%	$570	1.90%
Kathy	$875	$275	$1,150	4.60%	$475	1.90%
Jim	$0	$0	$0	0.00%	$0	0.00%
Ralph	$600	$220	$820	4.10%	$380	1.90%
Adjusted ADP = 5.25%; Adjusted ACP = 1.58%						

The combined amount in column (4) is the sum of the elective deferrals in column (2) and the shifted QMACs in column (3). The Adjusted ADP of the NHCEs is the ADP

[83] Treas. Reg. §1.414(v)-1(d)(2)(iii).

recalculated after the QMACs are shifted to the ADP test. The Adjusted ACP of the NHCEs is the ACP recalculated after the shifted QMACs are disregarded.

Comments on Calculations

18. Because Jim is at zero percent, every 1 percent of the other NHCEs' compensation that is treated as QMACs reduces the ACP by 0.83 percent: (5 x 1%)/6 = 0.83%. This illustration is merely one way of moving a portion of the QMACs to the ADP test. The administrator does not have to treat QMACs uniformly for all participants. For example, it may elect to move the QMACs of only certain employees to the ADP test, and leave all the QMACs of other employees in the ACP test.
19. When this approach is taken, the ADP test is passed. The ADP of the HCEs remains at the original 7.24 percent (shown in the prior EXAMPLE 3-39), because none of the QMACs made for the HCEs are included in the ADP test. The adjusted ADP of the NHCEs (which includes the QMACs that were moved to the ADP test) is 5.25 percent, and is now within 2 percent of the HCEs' ADP, passing the 2 percent spread test.
20. The ACP test is still passed when only the non-shifted QMACs are included. The ACP of the HCEs remains at 3.00 percent, because none of the HCEs' matching contributions were shifted to the ADP test. The adjusted ACP of the NHCEs (which excludes the QMACs shifted to the ADP test) is 1.58 percent, permitting up to a 3.16 percent ACP limit (two times the 1.58 Adjusted NHCE ADP) under the 2 percent spread test.

EXAMPLE 3-42. Shifting with Prior Year Testing. Let us compare this shifting rule if the plan in the prior **EXAMPLE 3-41** is using the prior year testing method for the plan year in question, rather than the current year testing method. The NHCE information for the prior plan year is shown below.

Note that Kathy is not in the eligible group, as she was in the prior **EXAMPLE 3-41**. This is because Kathy just became eligible in the current plan year. Also note the inclusion of Benjamin and Martin. They were eligible NHCEs in the prior plan year, but terminated before the end of that year, so in the prior **EXAMPLE 3-41** they were not included in the group of eligible NHCEs for the current plan year. Gene, Michelle, Romi, Jim, and Ralph were also eligible in the prior year.

The data shown below are their prior year compensation, prior year elective deferrals and prior year matching contributions. Assume the matching contributions made for the prior plan year satisfied the definition of QMACs. Also assume the matching contribution formula for the prior year was the same as for the current year.

Employee	Compensation	Deferrals	ADP	Match	ACP
Gene	$48,000	$3,840	8.00%	$1,440	3.00%
Michelle	$38,000	$2,334	6.14%	$1,140	3.00%

Romi	$29,000	$1,306	4.50%	$870	3.00%
Jim	$20,000	$0	0.00%	$0	0.00%
Ralph	$18,000	$450	2.50%	$450	2.50%
Benjamin	$25,000	$1,500	6.00%	$750	3.00%
Martin	$15,000	$0	0.00%	$0	0.00%
ADP = 3.88%; ACP = 2.07%					

Without shifting any QMACs to the ADP test, the ADP test is failed. The prior year ADP of the NHCEs is 3.88 percent, producing an ADP limit of 5.88 percent under the 2 percent spread test. The ADP of the HCEs for the plan year is 7.24 percent (shown in the prior **EXAMPLE 3-39**), so the test fails. Note that the ADP of the HCEs is still based on current year information because the purpose of the ADP test is to limit the current year elective deferrals of the eligible HCEs. The ACP test is passed.

The prior-year ACP of the NHCEs is 2.07 percent, permitting an ACP limit of 4.07 percent. The ACP of the HCEs (shown in the prior **EXAMPLE 3-39**) is only 3.00 percent. Again, the ACP of the HCEs is still based on current year information because the purpose of the ACP test is to limit the matching contributions of the eligible HCEs.

If no QMACs are shifted to the ADP test, and there are no QNECs made to correct the ADP violation, a corrective distribution in the amount that would be needed to pass the ADP test (subject to catch-up recharacterization, if the plan allows catch-up contributions) must be made in accordance with the leveling method.

Because the matching contributions satisfy the definition of QMACs, they can be used to raise the prior year ADP of the NHCE group if that would give us better correction results. Prior year QMACs are used for this purpose because prior year data are being used to calculate the ADP of the NHCEs. The same testing options described above are available when the prior year testing method is used.

EXAMPLE 3-43. Option #1: Combine All Matches With All Deferrals and Run Only the ADP Test. The following illustration assumes all the QMACs of both HCEs and NHCEs are shifted to the ADP test, leaving no ACP test. The data for the NHCEs are from the prior plan year because the plan is using the prior year testing method. The data for the current plan year (as given above) are being used for the HCEs.

Employee	Compensation	Deferrals	Match	Combined	Adjusted ADP
HCEs					
Ilene	$200,000	$11,000	$6,000	$17,000	8.50%
Donna	$98,000	$8,800	$2,940	$11,740	11.98%
Adjusted ADP = 10.24%					
NHCEs					
Gene	$48,000	$3,840	$1,440	$5,280	11.00%

Michelle	$38,000	$2,334	$1,140	$3,474	9.14%
Romi	$29,000	$1,306	$870	$2,176	7.50%
Jim	$20,000	$0	$0	$0	0.00%
Ralph	$18,000	$450	$450	$900	5.00%
Benjamin	$25,000	$1,500	$750	$2,250	9.00%
Martin	$15,000	$0	$0	$0	0.00%
Adjusted ADP = 5.95%					

Under this approach, the ADP of the HCEs is still more than two percentage points greater than ADP of the NHCEs: 10.24% - 5.95% = 4.29%, and is more than 1.25 times the ADP of the NHCEs: 5.95% x 1.25 = 7.44%. The corrective distribution required would be the amount necessary to reduce the ADP of the HCEs to 7.95 percent (2 percent plus the NHCE ADP of 5.95%). This would result in a reduction of the ADP by 2.29 percent. If the matching contributions had been left in the ACP test, the ADP of the HCEs would have to be reduced from 7.24 percent to 5.88 percent, requiring a reduction of 1.36 percent. So, Option #1 not only fails to eliminate the ADP failure, but increases the amount of the corrective distributions.

This same result occurred with the current year testing method in the EXAMPLE 3-40 above, but it is even worse under the prior year testing method because the prior year ADP of the NHCEs is lower than the current year ADP of the NHCEs.

EXAMPLE 3-44. Option #2: Shift a Portion of Match to ADP Test, and Test the Rest under ACP Test. Suppose a portion of the prior year QMACs for each NHCE, equal to 0.8 percent of the NHCE's compensation, is shifted to the ADP test. The remaining QMACs stay in the ACP test. The following is the result:

(1) Employee	(2) Deferrals	(3) Shifted QMACs	(4) Combined	(5) Adjusted ADR	(6) Non-shifted QMACs	(7) Adjusted ACR
Gene	$3,840	$384	$4,224	8.80%	$1,056	2.20%
Michelle	$2,334	$304	$2,638	6.94%	$836	2.20%
Romi	$1,306	$232	$1,538	5.30%	$638	2.20%
Jim	$0	$0	$0	0.00%	$0	0.00%
Ralph	$450	$144	$594	3.30%	$306	1.70%
Benjamin	$1,500	$200	$1,700	6.80%	$550	2.20%
Martin	$0	$0	$0	0.00%	$0	0.00%
Adjusted prior year ADP = 4.45%; Adjusted prior year ACP = 1.50%						

The combined amount in column (4) is the sum of the elective deferrals in column (2) and the shifted QMACs in column (3). The Adjusted prior-year ADP of the NHCEs is the ADP recalculated after the QMACs are shifted to the ADP test. The Adjusted prior-year

ACP of the NHCEs is the ACP recalculated after the shifted QMACs are disregarded. Because Jim and Martin are at zero percent, every 1 percent of the other NHCEs' compensation that is treated as QMACs reduces the ACP by 0.71 percent: (5 x 1%)/7 = 0.71%.

Note that this illustration is merely one way of moving a portion of the QMACs to the ADP test. The administrator does not have to treat QMACs uniformly for all participants. For example, it may elect to move the QMACs of only certain employees to the ADP test, and leave all the QMACs of other employees in the ACP test.

When this approach is taken, the ADP test is still failed, but by a lesser margin than when all of the QMACs are shifted or when none of the QMACs are shifted. The ADP of the HCEs remains at the original 7.24 percent, because none of the QMACs made for the HCEs are included in the ADP test. The adjusted ADP of the NHCEs (which includes the QMACs that were moved to the ADP test) is 4.45 percent. The 2 percent spread test would permit the ADP of the HCEs to be 6.45 percent.

The ACP test is still passed when only the non-shifted QMACs are included. The ACP of the HCEs remains at the original 3.00 percent, because none of the HCEs' matching contributions were shifted to the ADP test. The adjusted ACP of the NHCEs (which excludes the QMACs shifted to the ADP test) is 1.50 percent, permitting an ACP of 3.00 percent under the 2 percent spread test (two times the 1.50 percent NHCE ACP).

The failure margin for the ADP test is now 7.24% - 6.45%, or 0.79%, rather than the 2.29 percent failure margin shown in Option #1 or the 1.36 percent failure margin if there is no shifting of QMACs.

12-Month Contribution Rule for Timing of QMAC Deposits to the Plan

QMACs must be contributed by no later than 12 months after the close of the plan year for which they are allocated to be eligible for inclusion in the ADP test.[84] This is the same rule that applies to QNECs. In the current year testing EXAMPLE 3-39, QMACs made for both HCEs and NHCEs may be included in the ADP test only if actually contributed no later than 12 months after the close of the current plan year. In the prior year testing EXAMPLE 3-42, QMACs made for the NHCEs had to be contributed no later than 12 months after the close of the prior plan year, because QMACs made to the NHCEs for the prior plan year are taken into account. However, the QMACs shifted for the HCEs under Option #1 relate to the current year and must be contributed no later than 12 months after the close of the current plan year.

QMACs May Be Made to Separate Plan

An employer may make QMACs to a plan which is separate from the plan that contains the 401(k) arrangement.[85] The regulation requires that the separate plan must have the same plan year as the

[84] Treas. Reg. §1.401(k)-2(a)(6)(i).
[85] Treas. Reg. §1.401(k)-2(a)(6)(iii).

401(k) plan. Although this option is available, most employers make QMACs to the same plan that includes the 401(k) arrangement.

Uniform Testing Methods Must Be Used for ADP and ACP Tests to Shift QMACs

Plans cannot be aggregated unless they use the same testing method (either prior year or current year testing).[86] QMACs are technically part of the 401(m) portion of the plan, which is called the section 401(m) plan in the coverage regulations.[87] Therefore, QMACs are included in the coverage test for the 401(m) plan, even if they are used in the ADP test for the 401(k) plan rather than in the ACP test for the 401(m) plan. Because the QMACs are considered to be part of the 401(m) plan for coverage testing, then QMACs may not be used in the ADP test unless the plan uses the same testing method for both the 401(k) plan (the ADP test) and the 401(m) plan (the ACP test).[88]

EXAMPLE 3-45. Uniform Testing Method. A plan uses the prior year testing method for the ADP test but the current year testing method for the ACP test. The prior year ADP of the NHCEs could not include QMACs made for the prior year, because the QMACs are part of the 401(m) plan and the current year testing method applies to the 401(m) plan.

Match Subject to Vesting Schedule Must Be Tested in ACP Test

The shifting technique described above applies only to QMACs. Remember that one of the conditions for treating matching contributions as QMACs is that they are 100 percent vested without regard to the employee's length of service. Thus, matching contributions that are subject to a vesting schedule must be tested in the ACP test, even if such contributions have become 100 percent vested (or are 100 percent vested when contributed) because of the employee's length of service under the applicable vesting schedule. If a plan has a combination of QMACs and non-QMACs, the QMACs may be tested under either test (or split between the tests) and the non-QMACs must be tested under the ACP test.

3.10: Shifting Elective Deferrals to the ACP Test

Another shifting technique is to include elective deferrals in the ACP test. This approach may be used as a means of correcting a failure of the ACP test. Elective deferrals may be included in the ACP test only if two conditions are satisfied.

- The ADP test must be satisfied when all elective deferrals are included.[89]

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[86] Treas. Reg. §1.401(m)-2(a)(6)(ii), IRS Notice 98-1, Section III.
[87] See the definition of section 401(m) plan in Treas. Reg. §1.410(b)-9.
[88] Treas. Reg. §1.401(k)-2(c)(3).
[89] Treas. Reg. §1.401(m)-2(a)(6)(ii).

- The ADP test must be satisfied when only non-shifted elective deferrals are included. Under this second condition, the portion of the elective deferrals that is not included in the ACP test must still satisfy the ADP test.[90]

This dual testing requirement is different from the requirements for shifting QMACs to the ADP test. When QMACs are shifted to the ADP test, those amounts are not tested again in the ACP test. However, when elective deferrals are shifted to the ACP test, the contributions being shifted are actually tested under both tests.

It is possible that excess contributions under the ADP test might be recharacterized as catch-up contributions, if any of the HCEs who are catch-up eligible participants have not used up the full catch-up limit for the year involved. The plan may not apply the recharacterization rule first, and then determine how it wants to shift elective deferrals to produce different testing results. All testing must be completed, including the shifting of elective deferrals if desired, before determining whether there are any remaining excess contributions that would be distributable but are eligible for recharacterization as catch-up contributions.[91]

Designated Roth contributions are treated the same way as pre-tax elective contributions. So, if a participant has designated all or a portion of his or her elective deferrals as designated Roth contributions, the elective deferrals being shifted under this technique might, in fact, be designated Roth contributions.

EFFECT OF THE SHIFTING METHOD

The application of this testing technique depends on whether the plan is using the prior year testing method or the current year testing method to determine the ADP and ACP of the NHCEs. The same principles applicable to the use of QMACs apply to the shifting of deferrals. Elective deferrals that are shifted to the ACP test must be those made by eligible participants who are taken into account under the tests.

If the prior year testing method is being used, then the elective deferrals made by the NHCEs in the prior plan year may be shifted to the ACP test, and that will reduce the ADP of the NHCEs for the prior year for purposes of determining whether the ADP test is still satisfied after some of the elective deferrals are shifted (i.e., the second condition for using this testing approach, as described above). If the current year testing method is used to determine the ACP of the NHCEs, then the elective deferrals made by the NHCEs in the current plan year may be shifted, and that will reduce

[90] Treas. Reg. §1.401(k)-2(a)(5)(iv).
[91] Preamble to the final IRC §414(v) regulations. See 68 F.R. 40511.

the ADP of the NHCEs for the current year for purposes of determining whether the ADP test is still satisfied after some of the elective deferrals are shifted.

For the HCE group, the ACP is always determined based on current year data, so any shifting of elective deferrals to the ACP of the HCEs would relate to elective deferrals made by the HCEs for the current plan year.

ADDITIONAL SHIFTING RULES

Elective deferrals that are being shifted to the ACP test are part of the 401(k) portion of the plan (called the section 401(k) plan in the coverage regulations). Therefore, elective deferrals are included in the coverage test for the 401(k) plan, even if they are used in the ACP test. Because the elective deferrals are considered to be part of the 401(k) plan for coverage testing, elective deferrals cannot be shifted to the ACP test unless the plan uses the same testing method for both the 401(k) plan (the ADP test) and the 401(m) plan (the ACP test).[92] For example, suppose a plan uses the prior year testing method for the ADP test but the current year testing method for the ACP test. Elective deferrals made by the NHCEs for the prior plan year could not be shifted to the ACP test, because the elective deferrals are part of the 401(k) plan and different testing methods are being used for the ADP and ACP tests.

The regulations do not require that elective contributions be treated uniformly for testing purposes. The shifting may be done on an employee-by-employee basis.[93]

EXAMPLE 3-46. Current Year Testing Method. A 401(k) plan provides for a 50 percent matching contribution, with a maximum match of 3 percent of compensation. The plan also permits after-tax employee contributions. The plan uses the current year testing method to run the ADP and ACP tests. In this example, the employer had three NHCEs that deferred at very high rates, while the other three did not defer at all. These high percentages for employees Aggie, Brenda and Gene more than made up for the zero percent deferrals of the other NHCEs, so that the plan passes the ADP test easily. (The ADP of the HCEs is approximately 1.09 times the ADP of the NHCEs, satisfying the 1.25 test.)

(1) Employee	(2) Compensation	(3) Deferrals	(4) ADP	(5) Match	(6) After-Tax	(7) ACP
HCEs						
Keith	$200,000	$11,000	5.50%	$5,500	$1,600	3.55%
Angel	$100,000	$8,000	8.00%	$11,740	$0	3.00%
ADP = 6.75%; ACP = 3.28%						
NHCEs						
Aggie	$63,000	$9,450	15.00%	$1,890	$0	3.00%

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[92] Treas. Reg. §1.401(m)-2(c)(3).
[93] Treas. Reg. §1.401(m)-2(a)(6).

Brenda	$56,000	$6,720	12.00%	$1,680	$0	3.00%
Gene	$48,000	$4,800	10.00%	$1,440	$0	3.00%
Scott	$29,000	$0	0.00%	$0	$0	0.00%
Fredricka	$23,000	$0	0.00%	$0	$0	0.00%
Arlen	$20,000	$0	0.00%	$0	$0	0.00%
ADP = 6.17%; ACP = 1.50%						

The ACP test is a different story. Because there is a 3 percent cap on the match, the high deferral rates of Aggie, Brenda, and Gene do not help the ACP results. In addition, Keith has made after-tax contributions that increase his ACP. The ACP of the HCEs is 3.28 percent and the ACP of the NHCEs is 1.5 percent. Under the 2 percent spread test, the ACP limit for the HCEs is two times the ACP of the NHCEs, or 3.00 percent. Under the 1.25 test, the ACP limit for the HCEs is 1.25 times the ACP of the NHCEs, or 1.88 percent. The ACP of the HCEs fails both tests.

If the plan allows for catch-up contributions, the elective deferrals reflected in the third column would not reflect any of the catch-up contributions (i.e., elective deferrals that exceed an otherwise applicable limit, such as the IRC §402(g) limit, the IRC §415(c) limit or a plan-imposed limit). However, if the catch-up contributions were matched, those matching contributions would be included in the matching contribution column.

For example, if the year is 2019, and Keith, who is catch-up eligible, defers $20,000, rather than $11,000, his elective deferrals in column (3) would be $19,000 for ADP testing purposes (and for shifting purposes). However, because the plan matches 50 percent of elective deferrals, his match in column (5) would be $6,000, rather than $5,500, because 3 percent of Keith's compensation (i.e., the cap on the match) is $6,000. Furthermore, the elective deferrals made by the HCEs that are included in the ADP test [i.e., the amounts shown in column (3)] would not be subject to recharacterization as catch-up contributions, unless the plan proceeds with corrective distributions of a failed ADP test.

Because the ADP test is not failed in this example, there would be no such recharacterization anyway.

EXAMPLE 3-47. Portion of the Elective Deferrals May be Moved to the ACP Test. Suppose the elective deferrals of each NHCE in EXAMPLE 3-46, equal to 0.30 percent of compensation, are moved to the ACP test. The result is shown below. The amount in column (4), which is labeled ACP deferrals, is the amount of elective deferrals that have been moved to the ACP test. The amount in column (2), which is labeled ADP deferrals represents the elective deferrals remaining after transfer of some of the elective deferrals into the ACP test.

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(1) Employee	(2) ADP Deferrals	(3) Adjusted ADP	(4) ACP Deferrals	(5) Match	(6) After-Tax	(7) Adjusted ACP
Aggie	$9,261	14.70%	$189	$1,890	$0	3.30%
Brenda	$6,552	11.70%	$168	$1,680	$0	3.30%
Gene	$4,656	9.70%	$144	$1,440	$0	3.30%
Scott	$0	0.00%	$0	$0	$0	0.00%
Fredricka	$0	0.00%	$0	$0	$0	0.00%
Arlen	$0	0.00%	$0	$0	$0	0.00%
Adjusted ADP = 6.02%; Adjusted ACP = 1.65%						

Note that the Adjusted ADP of the NHCEs reflects the elective deferrals other than those shifted to the ACP test, and the Adjusted ACP of the NHCEs reflects the elective deferrals shifted to the ACP test (identified in column (4) as ACP deferrals). To obtain the Adjusted ACP of the NHCEs, each individual NHCE's ACR is determined by taking the sum of columns (4), (5), and (6), and dividing the result by that NHCE's compensation.

The administrator does not have to treat the elective deferrals uniformly for all participants. The only requirement is that all the elective deferrals (included those that are shifted) must satisfy the ADP test (which is shown in the original calculations in EXAMPLE 3-46) and any elective deferrals not moved to the ACP test must satisfy the ADP test (as shown above). For example, it would also be appropriate to move a portion of only Aggie's elective deferrals to the ACP test and not move any of the elective deferrals of the other NHCEs. However, we chose to move 0.30 percent of the elective deferrals of each of the NHCEs who deferred for the plan year.

When this approach is taken, the ACP test is passed on the basis of the 2 percent spread test. By moving 0.3 percent of each NHCE's elective deferrals to the ACP test, the adjusted ACP of the NHCEs is 1.65 percent. Under the 2 percent spread test, an adjusted ACP of 1.65 percent for the NHCE group would allow the HCE group's percentage to be twice that amount, or 3.30 percent. Because the HCE group's ACP is 3.28 percent, the plan now passes the ACP test. In addition, the ADP test is still passed. The adjusted ADP is calculated by taking into account only the non-shifted elective deferrals of each eligible NHCE. The adjusted ADP of the NHCEs is 6.02 percent. The 6.75 percent ADP for the HCEs is not more than 1.25 times the adjusted ADP for the NHCEs. No further correction is required.

EXAMPLE 3-48. Prior Year Testing Method. Let us compare this shifting rule if the plan in the prior EXAMPLE 3-46 is using the prior year testing method instead of the current year testing method.

Note that Arlen is not in the eligible group of NHCEs because he just became eligible in the current plan year. Also note the inclusion of Wayne. He was an eligible NHCE in the prior plan year, but he terminated before the end of that year, so in the prior **EXAMPLE**

3-46, he was not included in the group of eligible NHCEs for the current plan year. Aggie, Brenda, Gene, Scott and Fredricka were also eligible in the prior year.

The data shown below are the prior year compensation, prior year elective deferrals, prior year matching contributions and prior year after-tax employee contributions for the eligible NHCEs in the prior plan year.

(1) Employee	(2) Compensation	(3) Deferrals	(4) ADP	(5) Match	(6) After-Tax	(7) ACP
Aggie	$59,000	$8,850	15.00%	$1,770	$0	3.00%
Brenda	$54,000	$5,940	11.00%	$1,620	$0	3.00%

Without shifting any elective deferrals to the ACP test, the ADP test is passed but the ACP test is failed. The prior-year ADP of the NHCEs is 6.00 percent, yielding an ADP limit of 8.00 percent under the 2 percent spread test. The ADP of the HCEs for the plan year is 6.75 percent (shown in the prior **EXAMPLE 3-46**), so the test passes. Note that the ADP of the HCEs is still based on current year information. The ACP test is failed. The prior-year ACP of the NHCEs is 1.50 percent, permitting an ACP limit of 3.00 percent. The ACP of the HCEs (shown in the prior EXAMPLE 3-46) is 3.28 percent, so the limit is exceeded. Again, the ACP of the HCEs is still based on current year information.

Suppose that prior-year elective deferrals of each NHCE, equal to 0.30 percent of compensation, are shifted to the ACP test. The following adjusted testing results would be obtained.

(1) Employee	(2) ADP Deferrals	(3) Adjusted ADP	(4) ACP Deferrals	(5) Match	(6) After-tax	(7) Adjusted ACP
Aggie	$8,673	14.70%	$177	$1,770	$0	3.30%
Brenda	$5,778	10.70%	$162	$1,620	$0	3.30%
Gene	$4,365	9.70%	$135	$1,350	$0	3.30%
Scott	$0	0.00%	$0	$0	$0	0.00%
Fredricka	$0	0.00%	$0	$0	$0	0.00%
Wayne	$0	0.00%	$0	$0	$0	0.00%
Adjusted prior-year ADP = 5.85%; Adjusted prior year ACP = 1.65%						

The adjusted prior-year ACP of the NHCEs now produces an ACP limit of 3.30 percent under the 2 percent spread test (two times the 1.65 percent NHCE ACP). The ACP of the HCEs is 3.28 percent, so the ACP test is passed. The adjusted prior-year ADP of the NHCEs, which is now 5.85 percent, still passes the ADP test. The ADP of the HCEs is 6.75 percent.

3.11: Review of Key Concepts

- Name four ways to correct the ADP test.
- Name three ways to correct the ACP test.
- What is an excess contribution?
- What is an excess aggregate contribution?
- What is the leveling method?
- Calculate the allocable earnings on corrective distributions.
- Explain the timing and tax treatment of corrective distributions.
- How are corrective distributions reported?
- Explain when an excise tax may apply to corrective distributions.
- Explain when excess contributions can be recharacterized as after-tax employee contributions.
- Explain how QNECs and QMACs are used to correct an ADP or ACP testing failure.
- Calculate the amount of QNECs and/or QMACs necessary to correct a failed ADP or ACP testing failure.
- Explain how shifting QMACs to the ADP test can help pass the test.
- Explain how shifting elective deferrals to the ACP test can help pass the test.

3.12: For Practice – True or False

1. QNECs may be allocated to NHCEs to enable a 401(k) plan to pass the ADP test.
2. QMACs may use the six-year graded vesting schedule applicable to matching contributions.
3. One way to correct a failed ACP test is to recharacterize excess aggregate contributions as after-tax employee contributions.
4. Excess contributions that are distributed are not subject to the 10 percent penalty on early distributions.
5. Spousal consent is required for a corrective distribution in excess of $5,000.
6. Excess aggregate contributions are eligible rollover distributions.
7. The excise tax on corrective distributions made more than 2½ months after the end of the plan year is paid by the participant.
8. If a corrective distribution consists partly of designated Roth contributions and partly of pre-tax elective contributions, two Forms 1099-R would be required.
9. A plan must permit after-tax employee contributions in order to use the recharacterization method of correcting a failed ADP test.
10. Excess aggregate contributions that are distributed to plan participants are reported as taxable to the participant on Form 1099-R.

3.13: Sample Test Questions

1. Based on the following information, determine the lowest QNEC allocated to all NHCEs that will satisfy the ADP test:

    - This plan is the only plan sponsored by the employer.
    - The plan is not top-heavy.
    - The ADR is the same for the current and prior years.
    - QNECs are allocated to all NHCEs pro rata based on compensation.

Participant	Compensation	ADR
HCE 1	$100,000	10%
HCE 2	$90,000	8%
NHCE 1	$50,000	6%
NHCE 2	$40,000	6%
NHCE 3	$30,000	6%
NHCE 4	$20,000	6%

    A. $0
    B. $1,400
    C. $1,680
    D. $3,300
    E. $4,200

2. All of the following statements regarding excess contributions are TRUE, EXCEPT:

    A. Excess contributions are the result of a failed ADP test.
    B. Excess contributions recharacterized as after-tax employee contributions will be tested in the ACP test.
    C. Excess contributions in a 401(k) plan without an EACA that are refunded more than 2½ months after the end of the plan year are subject to a 10 percent excise tax.
    D. Excess contributions are subject to mandatory 20 percent federal income tax withholding.
    E. Excess contributions may not be used to satisfy required minimum distribution (RMD) amounts under IRC §401(a)(9).

3. Based on the following information, determine the deadline for refunding excess aggregate contributions:

    - The plan year is October 1, 2018 to September 30, 2019.
    - The plan does not include an automatic enrollment feature.
    - The employer wants to avoid the excise tax penalty.
    - The plan does not have an EACA.

    A. October 1, 2018
    B. September 30, 2019

C. December 15, 2019
D. March 15, 2020
E. September 30, 2020

4. All of the following statements regarding correcting failed ADP and ACP tests are TRUE, EXCEPT:

A. Excess contributions may be refunded to HCEs to correct a failed ADP test.
B. Elective deferrals may be shifted to the ADP test to correct a failed ACP test.
C. Excess aggregate contributions may be distributed to HCEs to correct a failed ACP test.
D. QNECs may be allocated to NHCEs to correct a failed ADP test.
E. QMACs may be shifted to the ADP test to correct a failed ADP test.

5. Based on the following information, determine the amount of excess contributions refunded to HCE A for the plan year:

- The total amount of corrective distributions that are excess contributions is $5,400.
- HCE A is not catch-up eligible.
- The HCE elective deferrals are:

Participant	Elective Deferral
HCE A	$10,000
HCE B	$8,200
HCE C	$5,600

A. $0
B. $500
C. $1,800
D. $3,600
E. $5,400

6. Based on the following information, determine the amount of excess contributions to be refunded to HCE A:

- The ADP for the NHCEs is 5%.
- None of the HCEs are catch-up eligible.

Participant	Compensation	Elective Deferral
HCE A	$200,000	$12,000
HCE B	$100,000	$10,000

A. $0
B. $500
C. $1,000
D. $1,500

E. $2,000

7. All of the following statements regarding correcting failed ADP and ACP tests are TRUE, EXCEPT:

    A. If the applicable earnings on a corrective distribution are negative, the corrective distribution is reduced by the loss.
    B. Sponsors of 401(k) plans with an EACA do not have to pay an excise tax if excess contributions are distributed within 6 months of the plan year end.
    C. Nonvested excess aggregate contributions are forfeited.
    D. Excess contributions that are recharacterized as catch-up contributions are not distributed.
    E. ADP and ACP tests are rerun after the corrective distributions are calculated to ensure they satisfy the nondiscrimination requirements.

8. Which of the following statements regarding shifting techniques is/are TRUE?

    I. The elective deferrals of some participants and not others may be shifted to the ACP test.
    II. Elective deferrals shifted to the ACP test are not tested in the ADP test.
    III. QMACs that are shifted to the ADP test must still be tested in the ACP test.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

9. Based on the following information, determine the amount of excess aggregate contributions to be refunded to HCE A:

    - The ACP for the NHCEs is 9%.
    - Both HCEs are 100% vested in their matching contributions.

Participant	Compensation	Elective Deferral
HCE A	$125,000	$16,250
HCE B	$120,000	$13,800

    A. $1,243.75
    B. $2,187.50
    C. $2,468.75
    D. $2,487.50
    E. $2,755.00

10. Based on the following information, determine the excise tax payable by the following employer:

Excess contributions	$3,000
Earnings on excess contributions	$50

Excess aggregate contributions	$1,000
Earnings on excess aggregate contributions	$30
Total returned to HCE 8 months after plan year end	$4,080

F. $400
G. $408
H. $600
I. $612
J. $816

See next page for answers to the true/false and sample test questions.

3.14: Solutions to True or False Questions

1. True.
2. False. QMACs must be 100 percent vested and subject to the 401(k) withdrawal restrictions.
3. False. One way to correct a failed ADP test is to recharacterize excess contributions as after-tax employee contributions. Excess aggregate contributions may not be recharacterized as after-tax employee contributions.
4. True.
5. False. Spousal consent is not required for a corrective distribution due to an ADP or ACP failure, even if the amount is over $5,000 and even if the plan is otherwise subject to QJSA requirements.
6. False. Corrective distributions made due to a failed ADP or ACP test are not eligible for rollover.
7. False. The 10 percent excise tax due on corrective distributions made after the deadline is payable by the employer.
8. True.
9. True.
10. True.

3.15: Solutions to Sample Test Questions

1. The answer is **B**.

   HCE ADP = (10% + 8%) / 2 = 9%
   NHCE ADP = (6% + 6% + 6% + 6%) / 4 = 6%
   To pass the 2 percent spread test, the NHCE ADP needs to be 7 percent. A QNEC of 1 percent of compensation will raise the NHCE ADP to 7 percent. The QNEC will total $1,400 = ($50,000 + $40,000 + $30,000 + $20,000) x 1%.

2. The answer is **D**. Excess contributions are not eligible for rollover. Therefore, they are not subject to 20 percent mandatory withholding rules. Instead, they are subject to the withholding rules for distributions that are not eligible rollover distributions (i.e., 10 percent withholding unless the recipient waives withholding).
3. The answer is **C**. Excess aggregate contributions must be returned within 2½ months of the end of the plan year in order to avoid an excise tax penalty. The plan year ends September 30, 2019, so the deadline is December 15, 2019.
4. The answer is **B**. Shifting elective deferrals into the ACP test is a way to correct a failed ACP test.
5. The answer is **D**. The amount of returns is determined using the leveling method.

Step 1: HCE A is returned $1,800. This brings HCE A's elective deferrals to the same dollar amount as HCE B's elective deferrals ($8,200).

Step 2: The remaining amount to be returned is $3,600 ($5,400 - $1,800). $1,800 is returned to HCE A and $1,800 is returned to HCE B, leaving elective deferrals for each of $6,400.

Step 3: Total amount returned to HCE A is $1,800 + $1,800 = $3,600.

6. The answer is **E**. The ADP of the HCE group must satisfy either the 1.25 test or the 2 percent spread test. Because the plan needs to pass only one of the two tests, the greater of the two results under these tests sets the limit for the ADP of the HCE group. The 1.25 test result is 6.25% (5% * 1.25). The 2 percent spread test result is 7% [the lesser of 5% x 2 (10%) or 5% + 2% (7%)]. Thus, the maximum HCE ADP is 7%.

   The current HCE ADP is 8%.
   HCE A: $12,000 / $200,000 = 6%
   HCE B: $10,000 / $100,000 = 10%
   HCE ADP: (6% + 10%) / 2 = 8%

   Under Step #1 of the refund calculations, the total distribution amount is calculated as if the distributions would be based on the ADRs of the HCEs, reducing them in descending order of their respective percentages. If we reduce HCE B's elective deferral to 8% ($100,000 x 8% = $8,000), the HCE ADR would be 7% [(6% + 8%) / 2 = 7%].
   HCE B's original elective deferral of $10,000 was reduced to $8,000, resulting in $2,000 ($10,000 - $8,000) to be refunded.

   Under Step #2 of the refund calculations, the total amount to be distributed now must be allocated among the HCEs based on the dollar amount of their elective deferrals.
   Since HCE A deferred the highest dollar amount, we reduce the HCE A's elective deferral amount first. This accounts for the entire $2,000 refund to be allocated ($12,000 - $2,000 = $10,000).

   The total excess contributions to be refunded to HCE A are $2,000.

7. The answer is **E**. It not necessary to perform the ADP or the ACP tests after the corrective distributions are calculated. Due to the nature of the leveling method, the tests may not pass if the ADRs or ACRs of the HCEs are recalculated after the distributions are made. However, the tests are deemed to be passed.

8. The answer is **A**. When QMACs are shifted to the ADP test, those amounts are not tested again in the ACP test. However, when elective deferrals are shifted to the ACP test, the contributions being shifted are actually tested under both tests.

9. The answer is **C**. The ACP of the HCE group must satisfy either the 1.25 test or the 2 percent spread test. Because the plan needs to pass only one of the two tests, the greater of the two results under these tests sets the limit for the ACP of the HCE group. The 1.25 test result is 11.25% (9% * 1.25). The 2 percent spread test result is 11% [the lesser of 9% x 2 (18%) or 9% + 2% (11%)]. Thus, the maximum HCE ACP is 11.25%.

The current HCE ACP is 12.25%.

HCE A: $16,250 / $125,000 = 13.00%

HCE B: $13,800 / $120,000 = 11.50%

HCE ACP: (13.00% + 11.50%) / 2 = 12.25%

Under Step #1 of the refund calculations, the total distribution amount is calculated as if the distributions would be based on the ACRs of the HCEs, reducing them in descending order of their respective percentages. If we reduce HCE A's matching contribution to 11.25% ($125,000 x 11.25% = $14,062.50) and HCE B's matching contribution to 11.25% ($120,000 x 11.25% = $13,500.00), the HCE ACP would be 11.25% [(11.25% + 11.25%) / 2 = 11.25%].

HCE A's original matching contribution of $16,250.00 was reduced to $14,062.50, resulting in $2,187.50 to be distributed. HCE B's original matching contribution of $13,800.00 was reduced to $13,500.00, resulting in $300.00 to be distributed. The total amount of excess aggregate contributions to be distributed is $2,487.50 ($2,187.50 + $300.00).

Under Step #2 of the calculations, the total amount to be distributed must now be allocated among the HCEs based on the dollar amount of their matching contributions.

Since HCE A had the highest dollar amount of matching contribution, we reduce HCE A's matching contribution first. If we distribute $2,450.00, HCE A's matching contribution will be reduced to the same dollar amount as HCE B's matching contribution ($16,250.00 - $2,450.00 = $13,800.00). This leaves $37.50 to be distributed. The $37.50 is divided equally among HCE A and HCE B ($37.50 / 2 = $18.75).

The total excess aggregate contributions to be refunded to HCE A are $2,468.75 ($2,450.00 + $18.75).

10. The answer is **A**. Corrective distributions must be made no later than 2½ months after the close of the plan year in order to avoid the excise tax. A plan with an EACA is allowed to make ADP/ ACP refunds up to six months after the close of the plan year to avoid the excise tax. In this case, the corrective distributions were made eight months after the end of the plan year so they are late regardless of whether the plan is an EACA.

    The excise tax is equal to 10 percent of the amount of the excess contribution (determined before the adjustment for allocable earnings), in the case of a corrective distribution under the ADP test, or 10 percent of the amount of the excess aggregate contribution (determined before adjustment for allocable earnings), in the case of a corrective distribution under the ACP test. Excess contributions plus excess aggregate contributions total $4,000 ($3,000 + $1,000). Thus, the excise tax is $400 ($4,000 x 10%).

CHAPTER 4:

SPECIAL COVERAGE AND ADP/ACP TESTING RULES

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4.01: Key Terms

- Deemed 3 percent rule
- Disaggregated plans testing method
- Disaggregation
- Double-counting limits
- Early participation rule
- IRC §410(b)(6)(C) transition period
- Mandatory aggregation rule
- Otherwise excludable employee
- Permissive aggregation
- Plan coverage change
- Restructuring
- Statutory employee
- Successor plan

4.02: Introduction

Once you have mastered the standard steps in coverage and ADP and ACP testing, there are a series of special rules that may apply. Some are mandatory, such as the adjustment of prior year ADPs and ACPs when a 401(k) plan has a significant change in coverage related to an acquisition, disposition or merger. Others are optional, and may be used to assist the plan in passing the nondiscrimination testing.

This chapter discusses these special rules and when and how they apply.

4.03: Double-Counting Limits

A plan may change testing methods so that the method used for a plan year might be different than that which was used for the previous plan year. When the plan switches from using the current year testing method in a plan year (Plan Year 1) to using the prior year testing method in the next plan year (Plan Year 2), the NHCE data from Plan Year 1 is being used twice for testing purposes: once to run the test for Plan Year 1, because the current year testing method was used for that year, and again to run the test for Plan Year 2, because the prior year testing method is used for that year.

Because the NHCE data from Plan Year 1 has already been used to run the tests in that plan year, the double-counting limits affect how that data is used again when the prior year testing method is used in Plan Year 2. The double-counting limits apply only after there is a switch from using the current year testing method in one plan year to the prior year testing method in the next plan year.[1]

EFFECTS OF DOUBLE-COUNTING LIMITS

If the prior year NHCE ADP (which has already been used for testing because the current year testing method was used in Plan Year 1) included QNECs, it must be adjusted before it can be used to set the ADP limit for the HCEs in Plan Year 2. Similarly, the prior year NHCE ACP must be adjusted before it can be used to set the ACP limit for the HCEs in Plan Year 2, if it includes

[1] Treas. Reg. §1.401(k)-2(a)(6)(vi) (including QNECs in the ADP test) and §1.401(m)-2(a)(6)(vi) (including QNECs in the ACP test).

QNECs. Unless QNECs were used to adjust the NHCE ADP or ACP in the prior plan year, the double-counting limits will not result in any adjustments to those prior year percentages.[2]

CONTRIBUTIONS THAT ARE DISREGARDED FROM NHCE PRIOR YEAR DATA FOR PLAN YEAR 2

To determine the prior year ADP or ACP of the NHCEs, to establish the ADP and ACP limits for the HCEs for Plan Year 2 (i.e., the plan year that the switch to the prior year testing method is effective), certain contributions must be disregarded under the double-counting limits rule.

QNECs Used for Testing in the Prior Plan Year

All QNECs that were used in the ADP test or ACP test performed for Plan Year 1 must be disregarded in Plan Year 2. This rule recognizes that these QNECs were used to help the plan pass the ADP test or ACP test for Plan Year 1 (or fail by a lesser margin), because the current year testing method was used in that year. The IRS is not willing to allow the same QNEC dollars a second time to help pass the following plan year's test.

QMACs may be counted in both years when there is a change in testing method.

EXAMPLE 4-1. QNECs Used in ADP Test. A 401(k) plan that uses the current year testing method for Plan Year 1 switches to the prior year testing method for the next plan year (Plan Year 2). Les is an NHCE and a participant in the 401(k) arrangement for Plan Year 1. His contributions for that plan year include the following: $2,600 of elective deferrals, $800 QNECs and $700 QMACs. There are no matching contributions other than the QMACs. Les' compensation for Plan Year 1, as used for ADP and ACP testing purposes, is $50,000. All of the QNECs allocated to Les for Plan Year 1 are used in the ADP test for that year. Les' ratios for Plan Year 1 are calculated as follows.

Actual Deferral Ratio (ADR) (ADP Test)	**Actual Contribution Ratio (ACR)** (ACP Test)
$3,400/$50,000, or 6.8%	$700/$50,000, or 1.4%

In running the ADP test and ACP tests for the next plan year (Plan Year 2), the plan is looking at Les' data for Plan Year 1, because the plan has switched from the current year testing method to the prior year testing method to run those tests.

Calculation of prior year ADR. To calculate Les' prior year ADR to be used for the ADP test performed for Plan Year 2, the same $2,600 of his elective deferrals are counted. None of the QNECs allocated to Les during Plan Year 1 may be included in his prior year ADR because his QNECs were used in the ADP test for Plan Year 1. Les's adjusted prior year ADR is $2,600/$50,000, or 5.2 percent.

Calculation of prior year ACR. To calculate Les' prior year ACR to be used for the ACP test performed for Plan Year 2, the numerator remains $700. The prior year ACR remains

[2] Treas. Reg. §1.401(k)-2(a)(6)(vi) and §1.401(m)-2(a)(6)(vi).

at $700/$50,000, or 1.4 percent because the double-counting limits do not apply to QMACs.

Cushion of QNECs Used in Prior Year Deferral Percentage

If the employer wants to take into account QNECs in calculating Les' prior year percentages, then not all of the QNECs should be used for testing in Plan Year 1. Suppose that of the $800 of QNECs allocated to Les for Plan Year 1, only $650 is included in the ADP test performed for Plan Year 1 (when the current year testing method was in effect). The other $150 of QNECs is not used in the ADP test or in the ACP test for Plan Year 1. When Les' prior year ADR or ACR is calculated to run the tests for Plan Year 2 (when the prior year testing method is used), the remaining $150 of QNECs that were not used in the tests for Plan Year 1 are permitted to be counted. All or part of the $150 may be used to boost Les' prior year ADR, if the employer wants to use it for the ADP test performed for Plan Year 2, and any part not used for the ADP test may be used to boost Les' ACR for the ACP test for Plan Year 2.

EXAMPLE 4-2. QNECs and QMACs Used in the ADP Test. A 401(k) plan uses the current year testing method for Plan Year 1. Lilly is an eligible NHCE under the 401(m) arrangement for that plan year. Her contributions for Plan Year 1 include the following: $1,000 of elective deferrals, $800 of QNECs, and $1,000 of QMACs. Her plan year compensation for ADP and ACP testing purposes is $40,000.

To perform the ADP test for Plan Year 1, the plan shifts $400 of Lilly's QMACs to the ADP test, and tests the remaining $600 of QMACs under the ACP test. All of the QNECs allocated to Lilly for the plan year are used in the ADP test. None of the elective deferrals are shifted to the ACP test for Plan Year 1. Thus, Lilly's ADR and ACR for testing purposes in Plan Year 1 are as follows.

ADR (ADP test)	ACR (ACP test)
$2,200/$40,000, or 5.5%	$600/$40,000, or 1.5%

The $2,200 numerator of Lilly's ADR is the sum of the elective deferrals ($1,000), the portion of the QMACs shifted to the ADP test ($400), and the QNECs ($800). The $600 in the numerator of her ACR is the remaining amount of QMACs that is not shifted to the ADP test.

The plan switches to the prior year testing method for the next plan year (Plan Year 2). In running the ADP test and ACP test for Plan Year 2, the plan is looking to the same data for Lilly that was used to run the ADP test and ACP test for Plan Year 1, because the plan has switched from the current year testing method to the prior year testing method to run those tests.

Calculation of prior year ADR. To calculate Lilly's prior year ADR to be used for the ADP test performed for Plan Year 2, the numerator is not $2,200. The $800 of QNECs that were included in the ADP test for Plan Year 1 must be subtracted. This leaves only $1,000 of elective deferrals and $400 of QMACs, for an adjusted prior year ADR of $1,400/$40,000, or 3.5 percent.

Calculation of prior year ACR. To calculate Lilly's prior year ACR to be used for the ACP test performed for Plan Year 2, the same $600 of her QMACs that was used in Plan Year 1 may be counted again, although the $400 used in the ADP test for Plan Year 1 must be disregarded. So, Lilly's prior year ACR remains at 1.5 percent, which is the ratio that was used in the ACP test for Plan Year 1 (when the current year testing method was in effect). None of the QNECs allocated to Lilly for Plan Year 1 may be included in her prior year ACR for the ACP test performed for Plan Year 2, because her QNECs were used in the ADP test performed for Plan Year 1.

EXAMPLE 4-3. QNECs Used for Testing in Plan Year 1. For Plan Year 1, a 401(k) plan uses the current year testing method to run the ADP test. The ADP for the NHCEs is 2.6 percent. QNECs are made to the NHCEs so that their ADP is increased to 3.1 percent, which is the percentage needed to pass the ADP test.

For the next plan year (Plan Year 2) the plan switches to the prior year testing method. When performing the ADP test for Plan Year 2, the prior year percentage of the NHCEs is only 2.6 percent, not 3.1 percent. The QNECs used in the ADP test for Plan Year 1 may not be double-counted by taking them into account again in the ADP test for Plan Year 2 through the mechanism of switching to the prior year testing method.

EXAMPLE 4-4. Cushion of QNECs. Let us build on EXAMPLE 4-3 above, where the double-counting limits require the prior year ADP of the NHCEs to be calculated as 2.6 percent (i.e., the pre-QNEC percentage) when performing the ADP for Plan Year 2 under the prior year testing method.

Suppose, instead, that for Plan Year 1 the employer contributes enough QNECs so that the ADP of the NHCEs would be raised to 3.4 percent rather than 3.1 percent. Then, only 3.1 percent is used as the ADP of the NHCEs in actually performing the ADP test for Plan Year 1. The rest of the QNECs, which would have raised the ADP of the NHCEs by another 0.3 percent, are not used in the ADP test or in the ACP test for Plan Year 1. Those QNECs are available to be used for the ADP or ACP test in Plan Year 2 under the prior year testing method because they have not been used yet for testing purposes. Therefore, the prior year ADP of the NHCEs, when performing the ADP test for Plan Year 2 may be calculated as 2.9 percent (i.e., 2.6% + 0.3%). These facts are summarized below.

1. ADP of NHCEs for Plan Year 1 (if no QNECs are included) = 2.6%
2. ADP of NHCEs after QNECs equal to 0.8% are contributed = 3.4%
3. ADP needed to pass ADP test for Plan Year 1 under current year testing method = 3.1%
4. QNECs described in (2) that are actually used in the ADP test for Plan Year 1 = 0.5%
5. QNECs described in (2) that are not used for the ADP test for Plan Year 1 = 0.3%

6. Prior year percentage for NHCEs when performing ADP test for Plan Year 2 = 2.9% (ADP from Plan Year 1 before QNECs are included, as described in (1), plus unused QNECs from Plan Year 1, as described in (5) above).

Double-Counting Limits Affect Tests Only in Plan Year 2

Only the tests performed in Plan Year 2 are affected by the double-counting limits because the NHCE data from Plan Year 1 is being counted for the second time. In the plan year that follows Plan Year 2, which is the second year that the prior year testing method is in effect after the switch, the data for the NHCEs used for testing has not been used previously for testing purposes. Therefore, no adjustments will be made to that prior year data.

EXAMPLE 4-5. Effect of Double-counting Limits in Year Following Year of Testing Method Change. A plan uses the current year testing method for Plan Year 1. The plan is then amended to the prior year testing method for Plan Year 2. The plan remains on the prior year testing method for Plan Year 3. The data used for the NHCEs for each of these years is as follows.

Plan Year Being Tested	Plan Year from which NHCE Data is Taken
Plan Year 1	Plan Year 1 (current year testing method)
Plan Year 2	Plan Year 1 (prior year testing method)
Plan Year 3	Plan Year 2 (prior year testing method)

As the table shows, the Plan Year 1 data for the NHCEs is being used twice for testing purposes. Therefore, the double-counting limits apply to the Plan Year 1 data when used again in performing the ADP and ACP tests for Plan Year 2. Any adjustments required by the double-counting limits are applied to the NHCE data for Plan Year 1 when performing the tests for the Plan Year 2.

When the tests are performed for the third plan year in the example (Plan Year 3), the double-counting limits are not applicable, even though the prior year testing method is being used for Plan Year 3. That is because the prior year testing method was also used for Plan Year 2. Therefore, the Plan Year 2 data for the NHCEs has not been used yet, and double-counting rules are not needed.

Plans That Do Not Make QNECs Are Not Affected

If a plan does not use QNECs for testing purposes, then the double-counting limits will have no effect, even if the plan switches from the current year testing method to the prior year testing method.

Consider Double-Counting Limits When Switching to Prior Year Testing

If a switch to the prior year testing method is being considered for a plan year, the impact of these double-counting limits must be considered. The employer may conclude that staying on the current year testing method is preferable.

4.04: Aggregation and Disaggregation Rules for 401(k) and 401(m) Arrangements

MANDATORY AGGREGATION RULE FOR HCES

If an HCE participates in more than one 401(k) arrangement of the same employer (or a controlled group or affiliated service group), the elective deferral amounts in all such arrangements are added together in computing the HCE's ADR under each arrangement.[3]3 This is called the mandatory aggregation rule. Similarly, if an HCE participates in more than one 401(m) arrangement of the employer (or a controlled group or affiliated service group), the contribution amounts in all such arrangements are added together in computing the HCE's ACR under each arrangement.[4]4 This rule applies even if the plans are not permissively aggregated for nondiscrimination testing purposes.

Note that this rule only aggregates contributions with respect to an HCE who participates in more than one plan of the employer. An HCE who participates in only one of the plans is not subject to this mandatory aggregation rule; his or her elective deferrals are included only in the ADP testing of the plan in which he or she participates.

Often, plans are designed to avoid participation by HCEs in more than one 401(k) plan of the company. Suppose, for example, that an HCE transfers from one controlled group member to another in the middle of a year, and that the two companies sponsor separate 401(k) plans. The plans may be written to provide that, in the event of a mid-year transfer by an HCE, the participant would continue to participate in the pre-transfer plan until the following year. This would avoid the HCE participating in more than one plan of the controlled group during the year.

The mandatory aggregation rule does not apply if the arrangements could not otherwise be permissively aggregated under coverage rules of IRC §410(b) [as permitted under Treas. Reg. §1.410(b)-7(d)].[5]5 For example, if an HCE participates in a union plan and in a nonunion plan

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[3] IRC §401(k)(3)(A) and Treas. Reg. §1.401(k)-2(a)(3)(ii).
[4] IRC §401(m)(2)(B) and Treas. Reg. §1.401(m)-2(a)(3)(ii).
[5] Treas. Reg. §§1.401(k)-2(a)(3)(ii)(B) and 1.401(m)-2(a)(3)(ii)(B).

because a part of the HCE's services is performed as a collective-bargaining employee and the other part of the HCE's services is performed as a nonunion employee, the HCE's elective deferrals, matching contributions and after-tax employee contributions under the two plans would not be aggregated, because union plans may not be aggregated with nonunion plans.

Although ESOPs and non-ESOPs generally are not eligible for aggregation, the regulations permit aggregation of ESOPs and non-ESOPs solely for purposes of ADP and ACP testing. Thus, an HCE's elective deferrals, matching contributions and after-tax employee contributions to an ESOP and a non-ESOP maintained by the same employer would be aggregated.[6]6

The mandatory aggregation rule applies to two or more plans in which an HCE participates even though the plans could not be permissively aggregated for coverage and nondiscrimination testing because they have a different testing method, the plans have different plan years or one of the plans is a safe harbor 401(k) plan.[7]

If the employer has elected, by filing Form 5310-A, to apply coverage and nondiscrimination testing on a qualified separate line of business (QSLOB) basis, then QSLOBs are disaggregated. When each disaggregated QSLOB maintains a separate 401(k) plan, this mandatory HCE aggregation rule apparently does not apply if an HCE participates in the plans of two different QSLOBs within the same plan year. However, there is a possible glitch here. Depending on how employees are allocated to QSLOBs, the employee might be considered employed by the same QSLOB through the plan year in which the overlapping participation occurs, resulting in aggregation of the contributions anyway.

The principles of this mandatory aggregation rule are addressed in the examples below.

EXAMPLE 4-6. Participation in Two 401(m) Arrangements. An employer maintains a 401(k) plan and a separate profit-sharing plan. The profit-sharing plan accepts after-tax employee contributions.

The 401(k) plan includes a matching contribution feature. Both the 401(k) plan and the profit-sharing plan have a 401(m) arrangement (i.e., the match in the 401(k) plan and the after-tax employee contributions in the profit-sharing plan).

One of the HCEs receives an allocation of matching contributions under the 401(k) plan equal to $5,000 and makes after-tax employee contributions to the profit-sharing plan equal to $3,000. The HCE's IRC §414(s) compensation for the plan year is $90,000. The HCE's ACR under the ACP test performed for each plan must be determined by combining his matching contributions and after-tax employee contributions under the two plans. His ACR for purposes of the ACP test performed for each plan is $8,000/$90,000, or 8.89 percent.

EXAMPLE 4-7. Transfer Between Two 401(k) Plans in the Same Year. A company maintains two 401(k) plans, one for its employees in Atlanta and the other for its

[6] Treas. Reg. §1.401(k)-1(b)(4)(v)(A).
[7] Treas. Reg. §1.401(k)-2(a)(3)(ii)(B) and §1.401(m)-2(a)(3)(ii)(B).

employees in Chicago. Both plans have a plan year ending December 31. During the current plan year, an HCE is transferred from Atlanta to Chicago. From January 1 through April 30, the HCE is eligible for the Atlanta plan and defers into that plan. From May 1 through December 31, she is eligible for the Chicago plan and defers into that plan.

The HCE deferred $2,000 into the Atlanta plan and $7,000 into the Chicago plan during the current plan year. Her compensation for that year is $100,000. Although the plans could be permissively aggregated for testing purposes, the company decides not to do that. Therefore, the plans are tested separately for ADP and ACP testing purposes. When each plan runs its ADP test, it must aggregate this HCE's elective deferrals under both plans.

The HCE's ADR under the Atlanta plan is 9 percent (i.e., $9,000/$100,000), even though she actually deferred only $2,000 into the Atlanta plan for that year, because the elective deferrals to the plans are aggregated. Similarly, when the Chicago plan runs its ADP test, it must aggregate this employee's elective deferrals under both plans. Therefore, the employee's ADR under the Chicago plan is also 9 percent (i.e., $9,000/$100,000), even though the employee actually deferred only $7,000 into the Chicago plan for that year.

Merely because these plans aggregate the contributions for the transferred HCE does not mean they take into account HCEs who participate only in the other plan. For example, the Atlanta plan’s ADP test would not include the ADRs of the HCEs who, for the entire plan year, participate only in the Chicago plan, unless the plans are permissively aggregated.

If You’re Curious …

Calculation of HCE Percentages When Plans Have Different Plan Years

If the mandatory aggregation rule applies to an HCE, and the plans covering the HCE have different plan years, the HCE’s contributions are aggregated by looking at contributions for the 12-month period that corresponds to the plan year of the plan being tested.[8]8 The compensation of the HCE is determined under the same 12-month period, using the definition of compensation under the plan being tested. Thus, if each plan performs ADP testing, the overlapping HCE’s contributions and compensation are determined with respect to each plan’s plan year period.

EXAMPLE 4-8. Plans with Different Plan Years. Corporations X and Y constitute a controlled group of corporations, so they are treated as a single employer. Each corporation maintains a separate 401(k) plan. Jonah, an HCE, is transferred from Corporation X to Corporation Y on March 1, 2020. After his transfer, he is no longer eligible for Corporation X’s plan but becomes immediately eligible for Corporation Y’s plan.

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[8] Treas. Reg. §1.401(k)-2(a)(3)(ii) (ADP testing) and §1.401(m)-2(a)(3)(ii) (ACP testing).

Plan X has a plan year ending June 30 and Plan Y has a plan year ending December 31. Thus, the plan years affected are the plan year beginning July 1, 2019, and ending June 30, 2020, for Plan X, and the plan year beginning January 1, 2020, and ending December 31, 2020, for Plan Y.

You have the following information about Jonah.

	7/1/19 – 12/31/19	**1/1/20 – 6/30/20**	**7/1/20 – 12/31/20**
Comp. from Corporation X	$90,000	$30,000	$0
Comp. from Corporation Y	$0	$65,000	$100,000
Deferrals to Plan X	$6,500	$2,200	$0
Deferrals to Plan Y	$0	$4,800	$8,000

Because Jonah is an HCE, Plan X must take into account Jonah's elective deferrals under Plan Y when it performs its ADP test, and Plan Y must take into account Jonah's elective deferrals under Plan X when it performs its ADP test.

With respect to Plan X, Jonah's elective deferrals for the plan year ending June 30, 2020, equal $13,500, taking into account his elective deferrals under both plans for the period July 1, 2019, through June 30, 2019 ($6,500 + $2,200 + $4,800). His compensation during that 12-month period, taking into account compensation from both Corporation X and Corporation Y, is $185,000 ($90,000 + $30,000 + $65,000). Jonah's ADR under Plan X for the plan year ending June 30, 2019, is 7.30 percent (i.e., $13,500/$185,000).

With respect to Plan Y, Jonah's elective deferrals for the plan year ending December 31, 2020, total $15,000, taking into account his elective deferrals under both plans for the period January 1 through December 31, 2020 ($2,200 + $4,800 + $8,000). His compensation during that 12-month period, taking into account compensation from both Corporation X and Corporation Y, is $195,000 ($30,000 + $65,000 + $100,000). Jonah's ADR under Plan Y for the plan year ending December 31, 2020, would be 7.69 percent (i.e., $15,000/$195,000).

As shown in **EXAMPLE 4-8**, each plan takes into account only 12 months of contributions and compensation for Jonah, based on the plans' respective plan year periods.

When computing the respective ADRs in each plan, the employee's compensation is determined in accordance with the definition used by the plan being tested. To illustrate, suppose in **EXAMPLE 4-8** above, that Plan X computes ADRs under the ADP test by excluding bonuses, but Plan Y computes ADRs under the ADP test by including bonuses. When computing Jonah's ADR under Plan X for the plan year ending June 30, 2020, any compensation paid during the plan year in the form of a bonus, whether from Corporation X or from Corporation Y, would be disregarded. However, when computing Jonah's ADR under Plan Y for the plan year ending December 31, 2020, any bonus paid to Jonah from Corporation X or from Corporation Y during such plan year period would be included. This rule would apply even if the plans have the same plan year.

Application of Aggregation Rule to Catch-up Contributions

The aggregation of the catch-up limit for multiple plans maintained by the same employer (or same related group) also affects the application of this mandatory

aggregation rule. Generally, the plans involved must use a reasonable method, which is consistent with the manner in which amounts are actually deferred under the plans, to apply the catch-up contribution rules to the respective plans.[9]

Corrective Distributions for HCEs Who Participate in More Than One Plan

If any of the plans in which the HCE participates must make corrective distributions under its ADP test, the HCE's total amount of elective deferrals, matching contributions and after-tax employee contributions under both plans is taken into account to determine his or her allocable refund amount.[10] If the refund amount so determined exceeds the amount of the relevant contributions in that plan, the difference is allocated to the HCE with the next highest dollar amount. For example, suppose the total elective deferrals made by an HCE to both plans is $11,000, but only $3,000 was contributed to the plan making the refund. If, based on $11,000, the HCE's excess contributions would be $4,000, only $3,000 is distributed (as adjusted for earnings) to that HCE, and the refund to the HCE with the next highest total dollar amount is increased by $1,000 (repeating this process, if necessary).

PERMISSIVE AGGREGATION OF 401(K) ARRANGEMENTS FOR TESTING PURPOSES

Under the coverage rules, plans may be aggregated to satisfy the coverage tests.[11] This is known as permissive aggregation, because the employer is deciding whether to aggregate the plans in demonstrating whether coverage is satisfied. If plans are not aggregated for coverage, they are treated as separate plans for nondiscrimination testing.

The definition of a plan for nondiscrimination testing purposes is linked to the definition for coverage testing purposes. Therefore, the plans must be treated as aggregated for coverage testing before they can be treated as a single plan under the ADP test or ACP test.[12] In some cases, two plans maintained by the employer are able to pass coverage separately, but the employer determines that aggregation of the two 401(k) arrangements would enable the plans to pass the ADP test (or fail by a lesser margin), whereas separate testing might result in one or both plans not passing (or failing by a greater margin). In such case, the employer may elect to permissively aggregate the plans for coverage testing to enable the aggregation of the arrangements for nondiscrimination testing, even though the plans are able to pass coverage separately.

EXAMPLE 4-9. Permissive Aggregation Elected to Pass Coverage. Company A operates two divisions: Division #1 and Division #2. The Company maintains separate 401(k) plans for each Division. The plan year under each plan ends December 31. For the current plan year, the Division #2 plan cannot pass the ratio percentage test for coverage purposes if the plan is tested separately. Rather than running the average benefit test to pass coverage, Company A elects to aggregate the Division #2 plan with the Division #1

[9] Treas. Reg. §1.414(v)-1(f).
[10] Treas. Reg. §1.401(k)-2(b)(2)(iii)(B) (ADP correction) and §1.401(m)-(b)(2)(iii)(B) (ACP correction).
[11] Treas. Reg. §1.410(b)-7(d).
[12] Treas. Reg. §1.410(b)-7(d).

plan to pass the ratio percentage test. This is known as permissive aggregation of the two plans, because the employer has elected to treat them as a single plan to pass coverage even though it is not obligated to do so.

Because the plans are being permissively aggregated to pass the ratio percentage test, the plans must be tested as a single plan for ADP testing purposes. The ADP of the HCEs is the average of the ADRs determined for all the HCEs under both plans. Similarly, the ADP of the NHCEs is the average of the ADRs determined for all the NHCEs under both plans.

If the plans are performing a single ADP test, contributions are aggregated under both plans for any employee (HCE or NHCE) who participates in both plans, rendering the mandatory aggregation rule for HCEs discussed above redundant, unless an HCE also participates in a third plan that is not being permissively aggregated with the plans in this example.

EXAMPLE 4-10. No Permissive Aggregation. Suppose that, instead of the facts in **EXAMPLE 4-9**, the 401(k) arrangement under each plan separately satisfies coverage for the plan year. In this case, the employer treats the plans separately for nondiscrimination purposes and each plan runs a separate ADP test.

If the plans are performing separate ADP tests, if any HCE participates in both plans, that HCE's contributions will be aggregated under the mandatory aggregation rule described above.

In **EXAMPLE 4-10**, Company A alternatively could aggregate the plans for coverage testing purposes, even though aggregation is not necessary to pass coverage, so that the employer can run a single ADP test. In other words, permissive aggregation might be necessary, as shown in **EXAMPLE 4-9**, because one or more of the plans cannot pass coverage separately, or may be elective, as shown in **EXAMPLE 4-10**, because aggregated nondiscrimination testing is desired.

Same Testing Method Required for Aggregated Plans

When the plans are permissively aggregated, the plans must use the same testing method (i.e., prior year testing method or current year testing method).[13] In EXAMPLE 4-9, the ADP of the NHCEs cannot be determined using the prior year data under Division #1's plan and using the current year data under Division #2's plan. Because a combined ADP is determined under the permissively aggregated plans, either the prior year testing method or the current year testing method must be

[13] Treas. Reg. §1.401(k)-1(b)(4)(iii)(B) and §1.401(m)-1(b)(4)(iii)(B).

used under both plans (i.e., the prior year data for the NHCEs under the two plans or the current year data for the NHCEs under the two plans).

Plans Must Have the Same Plan Year

One of the conditions for permissive aggregation is that the plans being aggregated have the same plan year.[14]14 In EXAMPLE 4-9 and EXAMPLE 4-10, if the Division #1 plan has a plan year ending June 30 and the Division #2 plan has a plan year ending December 31, the plans could not be aggregated.

Aggregation Rules and Safe Harbor 401(k) Plans

These aggregation rules apply to safe harbor 401(k) plans, too. If the mandatory aggregation rule described above applies to an HCE, and one of the plans in which the HCE participates is a safe harbor 401(k) plan, the elective deferrals the HCE makes under the safe harbor plan are taken into account by the plan in which the HCE also participates that is subject to ADP testing. Similarly, the matching contributions made by the HCE under the safe harbor 401(k) plan are taken into account in the plan in which the HCE also participates that is subject to ACP testing.[15]15

The mandatory aggregation may cause the safe harbor 401(k) plan to fail the ACP safe harbor under IRC §401(m)(11), but not the ADP safe harbor under IRC §401(k)(12).[16]16

If two 401(k) plans are permissively aggregated, the ADP safe harbor plan option is not available unless the plans, treated as a single plan, satisfy the safe harbor requirements. Furthermore, the ACP safe harbor is not available for the matching contributions unless the matching contribution formulas under the plans, treated as provided under a single plan, satisfy the safe harbor requirements. Therefore, a safe harbor 401(k) plan may not be permissively aggregated with a plan that is subject to ADP and ACP testing.[17]17

DISAGGREGATION RULES

As a general rule, a 401(k) arrangement within a plan is treated as a single 401(k) arrangement, subject to a single ADP test (unless a testing exception, such as the safe harbor rule under IRC §401(k)(12), applies). However, sometimes the 401(k) arrangement has to be divided up (known as disaggregation) as if it consisted of two or more separate 401(k) arrangements. When that happens, the disaggregated 401(k) arrangements apply the nondiscrimination testing rules as if they were separate plans. The same principles apply to the 401(m) arrangement under a plan.

The various types of disaggregation are:

1. disaggregation of statutory employees under IRC §410(a) and otherwise excludable employees;
2. disaggregation of union and nonunion portions of a plan;

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[14] Treas. Reg. §1.410(b)-7(d)(5).
[15] Notice 98-52, Section IX.B.2, Treas. Reg. §§1.401(k)-2(a)(3)(ii)(B) and 1.401(m)-(a)(3)(ii)(B).
[16] Notice 98-52, Section IX.B and Treas. Reg. §1.401(m)-3(d)(5).
[17] IRS Notice 98-52, Section IX.B, Treas. Reg. §1.401(k)-1(b)(4)(iii)(B), and §1.401(m)-1(b)(4)(iii)(B).

3. disaggregation of plans maintained by unrelated employers (multiple employer plans); and
4. disaggregation of plans covering employees of different QSLOBs.

Disaggregation is mandatory, except in the case of otherwise excludable employees, where the employer initially has discretion in how it chooses to demonstrate its plan passes coverage. But, if the employer elects to disaggregate otherwise excludable employees for coverage testing purposes for a plan year, then one of the disaggregation methods described below must be used to perform the ADP and ACP tests for such plan year. Conversely, if the employer does not elect to disaggregate otherwise excludable employees for coverage testing purposes for a plan year, then the disaggregation methods are not available for ADP and ACP testing for such plan year.

TESTING EXEMPTION FOR PLAN IF ONLY HCES OR ONLY NHCES ARE ELIGIBLE

The regulations provide that a 401(k) arrangement is deemed to pass the ADP test, and a 401(m) arrangement is deemed to pass the ACP test, under either of the following two situations:

1. all of the eligible employees in the arrangement are HCEs, or
2. all of the eligible employees in the arrangement are NHCEs.

All Eligible Employees Are HCEs

If all of the eligible employees are HCEs, a 401(k) arrangement is deemed to pass the ADP test and a 401(m) arrangement is deemed to pass the ACP test.[18]

Although the regulations refer to the eligible employees all being HCEs, this exception only works if the employer either has no NHCEs, or all of the NHCEs are excludable employees for coverage testing purposes.[19] If there is at least one NHCE who is not an excludable employee for coverage testing purposes, then a 401(k) arrangement that covers only the HCEs would fail to pass coverage, so it would not be a qualified plan. Furthermore, if the plan is aggregated with a separate plan that covers the nonexcludable NHCEs, pursuant to the permissive aggregation rules, then the aggregated plans are treated as a single plan, and this exception also would not apply.

EXAMPLE 4-11. HCE Only Exception to Coverage Testing. A 401(k) plan requires one year of service for eligibility purposes. The plan year ends December 31. The plan is maintained by a company that has three HCEs, all of whom are equal owners in the business and are eligible for the plan. The company hires its first NHCE in 2019, and that employee becomes eligible for the 401(k) arrangement on January 1, 2020. For plan years beginning before 2020, the plan is deemed to pass the ADP test because there are no eligible NHCEs. However, for the 2020 plan year, the plan covers one NHCE. The plan provides that the current year testing method is used for ADP testing purposes. The plan must satisfy the ADP test because, for that plan year, there is at least one eligible NHCE.

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[18] Treas. Reg. §§1.401(k)-2(a)(1)(i) and 1.401(m)-2(a)(1)(ii).
[19] Treas. Reg. §1.410(b)-6.

If the plan in **EXAMPLE 4-11** uses the prior year testing method, does the plan have one more year that it is deemed to pass (i.e., the 2020 plan year), pursuant to the rule discussed above? There are no eligible NHCEs for the prior plan year (i.e., the 2019 plan year), and the prior year testing method requires the plan to use prior year NHCE data to perform the test. Therefore, is the plan deemed to pass in that situation? The regulations state that the determination of whether this deemed-pass rule is satisfied is made in the prior plan year.[20] Thus, if the plan uses the prior year testing method and, in the prior plan year, the only eligible employees were HCEs, the plan is deemed to pass the ADP test (or ACP test, if applicable) for the current plan year.

All Eligible Employees Are NHCEs

If a plan covers only NHCEs (i.e., there are no eligible HCEs for the current plan year), nondiscrimination testing is not an issue because there are no HCEs who are benefiting from the plan. A 401(k) arrangement that benefits only NHCEs automatically satisfies the ADP test. Similarly, a 401(m) arrangement that benefits only NHCEs automatically satisfies the ACP test.

This rule would apply as well if there are HCEs who, in prior years, benefited under the 401(k) arrangement, but for the current plan year are not eligible to participate in the 401(k) arrangement, even if their account balances are still in the plan. This is because nondiscrimination testing is a plan-year-by-plan-year determination. As long as the only employees who are benefiting under the 401(k) arrangement (i.e., eligible to defer) for the current plan year are NHCEs, this deemed-pass rule applies.

Suppose a plan has HCEs who become eligible to participate for the first time for a plan year and the plan uses the prior year testing method. In this case, the deemed-pass rule is not applicable merely because the plan uses the prior year testing method. This is because the prior year testing method compares the current year ADP for the HCEs (which may not be zero in the year in which HCEs become eligible) with the prior year ADP of the NHCEs (who participated in that prior year and, therefore, the ADP is greater than zero).

SPECIAL DISAGGREGATION RULES FOR PLANS COVERING OTHERWISE EXCLUDABLE EMPLOYEES

The IRC and the 401(k) and 401(m) regulations provide for a special testing rule for plans that cover employees sooner than the law requires. These employees are called **otherwise excludable employees**. Specifically, an otherwise excludable employee is an eligible employee who would not have been an eligible employee if the one-year-of-service and/or age-21 age requirement

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[20] Treas. Reg. §1.401(k)-2(a)(1)(ii) (deemed pass of ADP test) and Treas. Reg. §1.401(m)-2(a)(1)(ii) (deemed pass of ACP test).

permitted by the IRC were imposed. Employees who have completed these maximum eligibility requirements are called **statutory employees**.

A plan may pass coverage by using the otherwise excludable employee rule. If the plan uses the otherwise excludable employee rule to test coverage, special testing rules must also apply to the ADP test and the ACP test performed under such plan.

Two ADP/ACP Testing Options for Otherwise Excludable Employees

If a plan disaggregates the otherwise excludable employees for coverage testing purposes, there are two options for treating such employees under the ADP and ACP tests:

a. the early participation rule testing method; or
b. the disaggregated plans testing method.

These testing options are intended to encourage employers to liberalize participation requirements in 401(k) plans. Some employers are reluctant to allow employees to participate if they have completed less than one year of service or if they are under age 21, because the participation levels of these groups tend to be lower than the participation levels for statutory employees. This makes the ADP test or ACP test harder to pass, because the overwhelming majority of otherwise excludable employees are generally NHCEs.

The **early participation rule** makes the ADP and ACP tests simpler to perform when otherwise excludable employees are disaggregated for coverage testing purposes, because only one set of tests is required.

Early Participation Rule

A plan that disaggregates otherwise excludable employees for coverage purposes may perform the ADP test and the ACP test, taking into account all statutory employees and only those otherwise excludable employees who are HCEs.[21] In other words, the otherwise excludable NHCEs are left out of the ADP and ACP tests entirely. This method of disaggregating otherwise excludable NHCEs is sometimes referred to as the "carve-out" method (i.e., carving out otherwise excludable NHCEs).

Effect of Prior Year Method

If the prior year testing method is used and the early participation rule is elected for ADP testing, the testing will include the eligible NHCEs who were statutory employees in the prior year, but leave out those NHCEs who were otherwise excludable employees for that year. However, the ADP of the HCEs, which is always based on current year data, will include all eligible HCEs, regardless of whether they are statutory employees or otherwise excludable employees. The same principles apply to the ACP test. (Remember, however, that an employee is highly compensated only if he or she earned in excess of a given dollar limit in the prior year or if he or she owns more than 5 percent of the company in the current or prior year. An otherwise excludable employee commonly has no employment in the prior year and, therefore, no compensation. As a result,

[21] IRC §401(k)(3)(F) and IRC §401(m)(5)(C).

generally the only otherwise excludable HCE is one who has ownership—a fairly rare circumstance.)

If, in the prior plan year, the plan did not disaggregate otherwise excludable employees for coverage testing purposes, the decision to use the early participation testing rule in the current plan year represents a plan coverage change, for which special rules apply to calculate the appropriate prior year percentage for the NHCEs.

Current Year Testing Method

If the current year testing method is used and the early participation rule testing approach is elected for ADP testing, the testing will include the eligible NHCEs who are statutory employees in the current year, but leave out those NHCEs who are otherwise excludable employees for the current year. The ADP of the HCEs is calculated in the same manner as described above (i.e., the ADP of the HCEs will include all eligible HCEs, regardless of whether they are statutory employees or otherwise excludable employees). The same principles apply to the ACP test.

Disaggregated Plans Testing Method Option

If the **disaggregated plans testing** method option is used for ADP or ACP testing, statutory employees and otherwise excludable employees are completely disaggregated, as if each group participates in a separate plan: one covering the otherwise excludable employees, and the other covering the statutory employees. A separate ADP and, if applicable, a separate ACP test, is performed for each disaggregated plan.[22]

Compare this to the early participation rule testing option, where only one ADP test and one ACP test is required because the otherwise excludable HCEs are included in the tests performed with respect to the statutory employees.

Prior Year Testing Method

Because the prior year data is used for the NHCEs under the prior year testing method, the eligible employees in the prior plan year who were NHCEs in that prior year are divided into statutory employees and otherwise excludable employees. However, the current year data is used for the HCEs, so the current year group of eligible HCEs is divided into statutory employees and otherwise excludable employees.

To determine if the statutory employees satisfy the ADP test under the prior year testing method, the ADP of the statutory NHCEs from the prior year is compared to the ADP of the statutory HCEs for the current year. To determine if the otherwise excludable employees satisfy the ADP test under the prior year testing method, the ADP of the otherwise excludable NHCEs from the prior year is compared to the ADP of the otherwise excludable HCEs for the current year. The same principles apply to the running of the ACP test.

Current Year Testing Method

Because the current year data is used for the NHCEs under the current year testing method, the eligible employees in the current plan year who are NHCEs in that year are divided into statutory

[22] Treas. Reg. §1.401(k)-1(b)(4)(iv) (ADP testing) and 1.401(m)-1(b)(4)(iv) (ACP testing).

employees and otherwise excludable employees. To determine if the statutory employees satisfy the ADP test under the current year testing method, the ADP of the statutory NHCEs for the current year is compared to the ADP of the statutory HCEs for the current year. To determine if the otherwise excludable employees satisfy the ADP test under the current year testing method, the ADP of the otherwise excludable NHCEs for the current year is compared to the ADP of the otherwise excludable HCEs for the current year. The same principles apply to the running of the ACP test.

Testing Might Not Be Required for Otherwise Excludable Group

If there are no otherwise excludable HCEs who are eligible employees for the current plan year, no ADP test or ACP test would be required for the otherwise excludable employees. The separate plan consisting of the otherwise excludable employees has no HCEs, so is deemed to pass the testing.

EXAMPLE 4-12. No Testing Needed for Otherwise Excludable Employees if there are No Otherwise Excludable HCEs. A 401(k) plan has a plan year ending December 31. The eligible employees for the 2019 and 2020 plan years are identified in the table below.

	2019 Plan Year			2020 Plan Year		
	Statutory Employees	Otherwise Excludable Employees	Total	Statutory Employees	Otherwise Excludable Employees	Total
HCEs	17	0	17	16	2	18
NHCEs	109	38	147	115	43	158
Total	126	38	164	131	45	176

Otherwise excludable employees are disaggregated for coverage testing purposes for both plan years. Because coverage testing is performed on a disaggregated basis, the plan must apply either the early participation rule or the disaggregated plans testing method to run the ADP and ACP tests for the 2019 plan year.

If the prior year testing method applies, then the ADP test is determined as follows:

Early participation rule testing option. The ADP of the all 18 HCEs for the 2020 plan year (including the otherwise excludable HCEs) is compared to the ADP of the 109 statutory NHCEs for the 2019 plan year (i.e., the 38 otherwise excludable NHCEs for that plan year are disregarded). A separate ADP test is not run for the otherwise excludable employees. If the ADP test is failed, corrective distributions would be determined with reference to all 18 eligible HCEs. The same principles apply to the running of the ACP test.

Disaggregated plans testing option. Two ADP tests are performed.

First, an ADP test for the statutory employees is done. Under that test, the ADP of the 16 statutory HCEs for the 2020 plan year is compared to the ADP of the 109 statutory NHCEs for the 2019 plan year. The same ADP for the NHCEs is used in this option as

for the early participation rule testing option, but only the statutory HCEs are limited by that ADP when the disaggregated plans testing option is used. If this first ADP test is failed, corrective distributions would be determined only with respect to the 16 statutory HCEs.

Second, an ADP test is performed only for the otherwise excludable employees. The ADP of the two otherwise excludable HCEs for the 2020 plan year is compared to the ADP of the 38 otherwise excludable NHCEs for the 2019 plan year. If this second ADP test is failed, corrective distributions would be determined only with respect to the two otherwise excludable HCEs. The same principles apply to the running of the ACP test.

If there were no eligible HCEs who are otherwise excludable employees, no ADP test would be performed for the otherwise excludable employees for this plan year.

If the current year testing method applies, then the ADP test is determined as follows:

Early participation rule testing option. The ADP of all 18 HCEs for the 2020 plan year is compared to the ADP of the 115 statutory NHCEs for the 2020 plan year (i.e., the 43 otherwise excludable NHCEs for the same year are disregarded from the ADP test). The HCE group for this test is the same as if prior year testing was used, because the ADP of the HCEs is always determined with regard to the current year. A separate ADP test is not run for otherwise excludable employees. The same principles apply to the running of the ACP test.

Disaggregated plans testing option. Two ADP tests are performed.

First, the ADP test is performed for the statutory employees. The ADP of the 16 statutory HCEs for the 2020 plan year is compared to the ADP of the 115 statutory NHCEs for the 2019 plan year.

Second, the ADP test for the otherwise excludable employees is performed. The ADP of the two otherwise excludable HCEs for the 2020 plan year is compared to the ADP of the 43 otherwise excludable NHCEs for the same year. The same principles apply to the running of the ACP test.

Remember that the ADP and ACP testing options described above are not elected in a vacuum. The employer first must elect to apply coverage testing under IRC §410(b) on a disaggregated basis. Thus, if coverage testing of a plan's 401(k) arrangement is performed on a disaggregated basis, then the ADP test is performed under one of the two testing options described above. Similarly, if coverage testing of a plan's 401(m) arrangement is performed on a disaggregated basis, then the ACP test is performed under one of the two testing options described above.

If the employer does not make the disaggregation election for coverage purposes, then the applicable nondiscrimination test should be performed by taking into account all eligible employees, regardless of whether they are statutory employees or otherwise excludable employees.

When the coverage tests are applied on a disaggregated basis, separate coverage tests are performed for the statutory employees and for the otherwise excludable employees, as if the two groups were in separate plans. This is true even if, for nondiscrimination testing purposes, the otherwise excludable HCEs are included in the same ADP (or ACP) test with the statutory HCEs,

and no separate ADP (or ACP) test is performed for the otherwise excludable group, in accordance with the early participation rule testing option described above.

If You're Curious …

Correction of ADP or ACP Violation when Disaggregation is Used

Corrective Distribution Method

The most common correction method is to make corrective distributions.[23]

If the early participation rule testing option is used, then the corrective distributions would be determined in the same manner as a plan that does not disaggregate. That is because the HCEs are not disaggregated for purposes of the ADP and ACP tests. Only the otherwise excludable NHCEs are disregarded from the nondiscrimination test. So, if an ADP test (or ACP test) is failed, and corrective distributions are made, the leveling method is applied to the HCE group as whole, both statutory employees and otherwise excludable employees, to determine who receives corrective distributions.

If, however, the disaggregated plans testing option is used, the plan is treated as two plans for nondiscrimination testing. If the plan is making corrective distributions to cure the failure to the ADP test (or ACP test), the distributions are determined for the HCEs who are included in the separate plan that has failed the applicable test. For example, if the plan covering statutory employees fails the ADP test, then the corrective distributions are determined by taking into account only the HCEs who are statutory employees. Similarly, if the plan covering otherwise excludable employees fails the ADP test, then the corrective distributions are determined by taking into account only the HCEs who are otherwise excludable employees. The same principles apply to the ACP test.

Allocation of QNECs

If the employer has elected disaggregation, and the employer wants to make QNECs to boost the percentage of the NHCE group, which NHCEs receive the allocation of QNECs? Under the early participation rule testing option, the employer might want to make the QNECs only for the NHCEs who are statutory employees, because the otherwise excludable NHCEs are excluded from the ADP and ACP tests. Under the disaggregated plans testing option, the employer might want to make QNECs only for the NHCEs who are statutory employees, if the ADP or ACP failure is with respect to the statutory employees, or only for NHCEs who are otherwise excludable employees, if the ADP or ACP failure is with respect to the otherwise excludable employees. To use this option, the plan must permit the employer to elect to make QNECs only on behalf of a disaggregated group of NHCEs.

Other Testing Techniques

QMACs may be included in the ADP test.[24] Under the early participation rule testing option, the HCEs who are otherwise excludable employees are included in the tests run on the statutory employees, so QMACs allocated to those HCEs would also have to be

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[23] Treas. Reg. §1.401(k)-2(b)(2) (ADP test correction) and Treas. Reg. §1.401(m)-2(b)(2) (ACP test correction).
[24] IRC §401(k)(3)(D).

taken into account in the applicable tests. QMACs allocated to the NHCEs who are otherwise excludable employees would be irrelevant because those employees would be excluded from the ADP and ACP tests. Under the disaggregated plans testing option, separate sets of ADP and ACP tests are performed on the statutory employees and on the otherwise excludable employees. Therefore, QMACs allocated to statutory employees would be taken into account for testing the plan covering statutory employees, and QMACs allocated to otherwise excludable employees would be taken into account for testing the plan covering otherwise excludable employees.

How QMACs are shifted with respect to each disaggregated plan could be determined independently. Similarly, IRC §401(m)(3) authorizes the technique of shifting some of the elective deferrals into the ACP test. The same principles described above with respect to QMACs would apply to the shifting of elective deferrals as well.

Other Restructuring Not Permitted for ADP and ACP Testing Purposes

The otherwise excludable employee rule is the only permitted testing option that divides the eligible employees into separate groups for ADP and ACP testing purposes. The Treasury refers to this as restructuring.

Disaggregation of Otherwise Excludable Employees From Safe Harbor 401(k) Plan

The IRS permits the aggregation and disaggregation rules applicable to 401(k) plans in general to apply also to safe harbor 401(k) plans.[25] Thus, a safe harbor 401(k) plan may be designed so that the safe harbor provisions apply only to statutory employees or only to otherwise excludable employees.

Employers that use this disaggregation in their safe harbor 401(k) plan designs usually exclude the otherwise excludable employees from the safe harbor provisions. By adopting this type of plan design, the employer is not required to make the safe harbor matching contribution or safe harbor nonelective contribution, whichever is applicable, to the employees who have not yet satisfied the statutory age and service requirements, even though these employees are eligible under the plan's age and service requirements to make elective deferrals under the 401(k) arrangement.

Where otherwise excludable employees are not eligible for the 401(k) safe harbor provisions, the ADP/ACP testing is required for the otherwise excludable employees if there is at least one HCE in the otherwise excludable employee group.[26] This is important. It makes clear that the early participation rule testing option, which eliminates only the otherwise excludable NHCEs from the ADP and ACP tests, is not permitted to be used under the ADP/ACP safe harbor provisions to eliminate the ADP/ACP tests for the otherwise excludable HCEs. It should be noted that use of

[25] IRS Notice 98-52, Section IX.B.1.
[26] IRS Notice 2000-3, Q&A-10.

this method may cause other nondiscrimination issues, particularly with regard top-heavy plans. See chapter 7 for a more in-depth discussion.

EXAMPLE 4-13. Safe Harbor 401(k) Provisions Limited to Statutory Employees. A 401(k) plan's eligibility requirements are three months of service and attainment of age 21. You have the following information for the current plan year:

	Statutory employees	Otherwise excludable employees
HCEs	12	2
NHCEs	132	21

If the plan did ADP/ACP testing for the plan year, the early participation rule testing option would allow the 21 NHCEs who are in the otherwise excludable employee group to be excluded from the test (assuming the current year testing method is used). This would allow the ADP for the 14 eligible HCEs (which includes the 2 HCEs who are otherwise excludable employees) to be limited by the ADP of the 132 NHCEs who are statutory employees, thus avoiding a separate ADP test for the otherwise excludable employees. The same approach could be used for the ACP test.

If the plan adds a 401(k) safe harbor feature and limits the 401(k) safe harbor provisions to the statutory employees, the ADP test may not be deemed passed for the two HCEs who are otherwise excludable employees. Thus, the employer will have to limit the ADP of these two HCEs based on the ADP of the 21 otherwise excludable employees who are NHCEs (or the similar NHCE group from the prior year, if the prior year testing method is used). The same would be true if the ACP safe harbor were satisfied solely with respect to the matching contributions for the statutory employees.

4.05: New Plans and Short Plan Years

The law applies special rules to a new 401(k) plan or new 401(m) plan. This section also discusses issues that arise with a short plan year, whether that short year is the first plan year of the plan, or is created when the plan year of an existing plan is amended.

DEEMED 3 PERCENT RULE

For a new plan, there is no prior year data for the NHCE group. Therefore, the IRC provides that the NHCE group's ADP is deemed to be 3 percent under the prior year testing method, unless the plan provides that it will determine the prior year ADP on the basis of the actual NHCE data for the first plan year.[27] If the actual NHCE data is used for the first plan year under a plan that uses the prior year testing method, then that data will be used twice for testing purposes: once for the ADP test run for the first plan year, and again for the ADP test run for the second plan year.

This **deemed 3 percent rule** applies only if the plan is otherwise using the prior year testing method. If the plan is going to use the actual data for the first plan year, rather than the 3 percent rule, what is the effect of the plan specifying that it uses the prior year testing method rather than

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[27] IRC §401(k)(3)(E).

the current year testing method? If the plan otherwise is using the prior year testing method, but decides to use the actual NHCE data for the first year to determine the prior year percentage, the plan is not treated as having switched testing methods when it uses the prior year testing method in the second plan year.[28] That means the double-counting limits that normally apply to a switch from the current year testing method to the prior year testing method would not apply. If the plan specifies that it is using the current year testing method for the first plan year, and then switches to the prior year testing method for the second plan year, then the double-counting rules would apply.[29]

If the plan uses the current year testing method, then the actual data for the current year must be used to determine the ADP of the NHCE group for the first plan year. In other words, the deemed 3 percent rule does not apply. In the second plan year, the plan is on the current year testing method, so the first year's NHCE data is not being used twice.

EXAMPLE 4-14. Deemed 3 Percent Rule Used. A company establishes a new 401(k) plan effective January 1, with a plan year ending December 31. The plan provides that it uses the prior year testing method. The plan further provides that, for the first plan year, the ADP of the NHCEs is deemed to be 3 percent. In that case, the ADP limit for the HCEs for the first plan year is 5 percent (i.e., two percentage points greater than the deemed 3 percent ADP of the NHCEs).

EXAMPLE 4-15. Actual Data Used. Suppose, instead, that the plan provides for the use of the actual data of the NHCEs for the first plan year. Assume that, for the first plan year, the ADP of the NHCEs is 4.1 percent. For the second plan year, the data for the NHCEs from the first plan year is used again to determine the ADP limit on the HCEs, as the plan uses the prior testing method. The double-counting rules are not applicable in using the first-year data of the NHCEs to perform the ADP test for the second plan year.

EXAMPLE 4-16. Plan Uses Current Year Testing Method. Suppose, instead, that the plan, as initially adopted, provides that it uses the current year testing method. Now, the actual data of the NHCEs for the first plan year must be used to run the ADP test for that year. The 3 percent rule is not available. In addition, if the employer amends the plan for the second plan year to provide for the prior year testing method, that is a switch in testing methods that is subject to the double-counting limits.

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[28] IRS Notice 98-1.

[29] See also, Treas. Reg. §1.401(k)-2(c)(2)(i) and §1.401(m)-2(c)(2)(i).

Suppose a profit-sharing plan is not new, but the employer is adding a 401(k) arrangement to the plan. Is the 401(k) arrangement treated as a new plan so that the deemed 3 percent rule can be used? The IRS says YES.[30]

EXAMPLE 4-17. Addition of 401(k) Feature to Existing Profit-Sharing Plan. A company has an existing profit-sharing plan with a plan year ending June 30. For the plan year beginning July 1, 2019, the company adds a 401(k) arrangement. The new plan rule applies to the ADP test for the first plan year ending June 30, 2020. The NHCE group may be deemed to have an ADP of 3 percent if the plan uses the prior year testing method for the first plan year.

It is possible that the elective deferrals made by the NHCEs in the first plan year are never used for ADP testing. Consider, for example, a 401(k) plan that uses the deemed 3 percent rule for the first year and is then amended to use the current year testing method for the second plan year. In that case, the actual NHCE data for the first year is never used for testing purposes.

Suppose a new 401(k) plan uses the deemed 3 percent rule for its first plan year, and then uses the prior year testing method for the second plan year. To calculate the ADP of the NHCE group for the second plan year, the prior year data for the NHCE group is the actual data from that first plan year. The ADP of 3 percent that was used to run the ADP test for the first plan year was a deemed percentage for the NHCE group that is used only for the first plan year. It is not treated as the actual percentage when determining the prior year percentage of the NHCE group for the second plan year's ADP test.

Successor Plan Rule

A plan may not use the 3 percent rule if it is a successor plan to a prior 401(k) plan. A successor plan for this purpose is a plan in which 50 percent or more of the eligible employees for the first plan year were eligible under another 401(k) plan maintained by the same employer in the prior year. The successor plan concept is also used to determine if a newly established plan may be treated as a new plan for purposes of the safe harbor 401(k) rules.[31]

EXAMPLE 4-18. Successor Plan and Deemed 3 Percent Rule. An employer maintains a single 401(k) plan for its Division A and Division B employees. The Division A employees are spun-off into another plan. The second plan covering the Division A employees is a successor plan, so the first-plan-year rule is not available. Therefore, the newly formed Division A plan may not deem the ADP of the NHCE group to be 3 percent in running its test for the first plan year. If the prior year testing method is used in the Division A plan, the prior year percentage is the ADP of the NHCE group from the single plan that was maintained in the prior plan year which covered both Division A and Division B employees.

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[30] Treas. Reg. §1.401(k)-2(c)(2)(ii).
[31] Treas. Reg. §1.401(k)-2(c)(2)(iii) and §1.401(m)-2(c)(2)(iii).

Who is the same employer for purposes of determining whether a new plan is a successor plan? If the prior plan was maintained by a member of the same related group that includes the employer that maintains the successor plan, the sponsor of the prior plan is the same employer.

EXAMPLE 4-19. Employees Transferred Within a Controlled Group. Corporation X maintains a 401(k) plan. Corporation X has a wholly owned subsidiary (Corporation Y). Fifty employees of Corporation X are transferred to Corporation Y. Corporation Y has 30 other employees. Corporation Y establishes a new 401(k) plan that covers all employees of Corporation Y. For the first plan year of Corporation Y's new plan, there are 80 eligible employees, including the 50 former Corporation X employees who were transferred.

Because the 50 former Corporation X employees constitute at least 50 percent of the eligible employees in the first plan year of the Corporation Y plan, and in the prior year they participated in Corporation X's 401(k) plan, the Corporation Y plan is a successor plan. The sponsor of the Corporation X plan is treated as the same employer as the sponsor of the Corporation Y plan, because Corporation X and Corporation Y are part of the same controlled group of businesses, as defined in IRC §414(b).

To run the ADP test for the first plan year, the Corporation Y plan may not use the deemed 3 percent rule. If the prior year testing method is used, the prior year percentage is taken from the Corporation X plan that covered the transferred employees.

If the employees in the prior plan were acquired by a new employer, the sponsor of the prior plan is the same employer if it is treated as a predecessor employer. The predecessor employer rule is based on the severance from employment concept, which is dependent on the type of transaction that results in the acquisition.

If You're Curious…

Asset Acquisition

Generally, in an asset acquisition, the prior employer is a predecessor employer only if the plan of that prior employer is being continued by the new employer (the purchaser).

EXAMPLE 4-20. Transfers Pursuant to Acquisition of Corporate Assets if Prior Employer's Plan is Not Assumed by New Employer. Corporation X acquires the assets of an operating division of Corporation Y, an unrelated company. Pursuant to the acquisition, 50 former Corporation Y employees become Corporation X employees. In the same year as it acquires these employees, Corporation X adopts a new 401(k) plan. The former Corporation Y employees will represent more than 50 percent of the eligible employees in the first year of Corporation X's plan. Corporation X does not assume sponsorship of Corporation Y's 401(k) plan nor does Corporation X agree to a merger of Corporation Y's plan into its new plan. Corporation X is not treated as the same employer as Corporation Y under the predecessor employer rules. Thus, Corporation X's new 401(k) plan is not a successor plan with respect to Corporation Y's 401(k) plan, and may use the deemed 3 percent rule if it uses the prior year testing method.

Stock Acquisition

In a stock purchase (or similar transaction involving nonstock ownership, such as a partnership interest), the employee is generally treated as continuing with the same employer and there is no severance from employment. If there is no severance from employment with respect to an acquired employee, then any plan for which the employee becomes eligible following the acquisition might be a successor plan.

Sale of a Subsidiary to an Unrelated Parent Company

If stock of a subsidiary corporation is sold by a parent company to a new and unrelated parent company (i.e., the sold company becomes the subsidiary of a different parent company and, thus, part of a different controlled group), the severance from employment concepts that pertain to asset sales generally apply.[32]

EXAMPLE 4-21. Sale of Subsidiary. Corporation S is the subsidiary of Corporation X. Corporation X sells 100 percent of its Corporation S stock to Corporation Y, an unrelated company.

Pursuant to this sale, Corporation S is now the wholly owned subsidiary of Corporation Y. Although Corporation S participated in the Corporation X controlled group 401(k) plan immediately prior to the sale, Corporation S no longer participates in such plan. In addition, the account balances of the Corporation S employees remained with the Corporation X plan and neither Corporation S nor new parent Company Corporation Y has agreed to continue to maintain the portion of the Corporation X plan that covered the Corporation S employees. This is treated as a severance from employment for the Corporation S employees because Corporation S is now the subsidiary of a different parent company.[33]

Shortly after the sale, Corporation Y establishes a Corporation Y plan in which its subsidiaries, including its new subsidiary, Corporation S, will participate. Although Corporation S maintained a 401(k) plan with its old parent company (Corporation X), it should be reasonable to treat the 401(k) plan maintained by controlled group Corporation Y as not being a successor plan for purposes of the deemed 3 percent rule. Thus, if the Corporation Y controlled group's 401(k) plan uses the prior year testing method, it should be reasonable to deem the NHCE group's ADP to be 3 percent.

[32] Notice 2002-4.
[33] Notice 2002-4.

Plan Document Requirements

When a new plan is established, it must specify whether it uses the prior year testing method or the current year testing method and, if it uses the prior year testing method, whether it will use the deemed 3 percent rule or the actual data of the NHCEs for the first plan year.

ACP TESTING FOR NEW PLANS

The rules for running the ACP test in the first year of a new 401(m) plan are similar to those applicable to the ADP test. If the plan is using the prior year testing method, the prior year ACP for the NHCE group is deemed to be 3 percent, the same as under the ADP test, unless the plan provides that the actual data of the NHCEs is used for the first plan year's ACP test.

Suppose a plan is not new, but the employer adds a 401(m) arrangement to the plan. Is the 401(m) arrangement treated as a new plan so that the deemed 3 percent rule can be used? The IRS says YES, the same as the rule for 401(k) plans.[34]

EXAMPLE 4-22. Match Added to 401(k) Plan. Company Z maintains a 401(k) plan. For the first five years of the plan, the plan does not include a matching contribution feature and no after-tax employee contributions are permitted. Effective January 1 of the sixth plan year, the plan is amended to add a matching contribution feature. That plan year is the first year the plan includes a 401(m) arrangement. If the plan uses the prior year testing method, the plan may provide that the NHCE group's ACP is deemed to be 3 percent for that first plan year of the 401(m) arrangement.

EXAMPLE 4-23. Matching Feature Added in Different Year than 401(k) Feature is Added. An employer maintains a profit-sharing plan. Effective January 1, 2019, the plan is amended to add a 401(k) feature. There are no matching contributions or employee after-tax employee contributions authorized by the plan. The plan provides that the prior year testing method is used for ADP testing purposes.

For the 2019 plan year, there is a new 401(k) arrangement, so the plan may provide that the prior year ADP of the NHCEs is deemed to be 3 percent. No ACP test is performed for the 2019 plan year because there is no 401(m) arrangement.

Effective January 1, 2020, the employer amends the plan again to add a matching contribution feature. The plan provides that the prior year testing method is also used for ACP testing purposes. For the 2020 plan year, there is a new 401(m) arrangement, so the plan may provide that the prior year ACP of the NHCEs is deemed to be 3 percent. However, if the prior year testing method is still in effect for the ADP test for the 2020 plan year, the actual prior year data from the 2019 plan year is used to calculate the ADP of the NHCEs.

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[34] Treas. Reg. §1.401(m)-2(c)(2)(ii).

Issues Arising with Discretionary Matching Contributions

A 401(m) arrangement is not treated as a new plan merely because the employer failed to make a matching contribution under a discretionary contribution formula in all prior years.

EXAMPLE 4-24. Dormant Discretionary Matching Contribution Program. A 401(k) plan has a discretionary matching contribution formula. The plan does not permit after-tax employee contributions. The plan uses the prior year testing method for both ADP and ACP testing purposes. For the first several plan years, the employer did not make matching contributions.

For the 2018 plan year, matching contributions are made by the employer for the first time. The deemed 3 percent rule is not available for determining the prior year ACP of the NHCEs. Their prior year ACP is zero percent because no matching contributions were made in that year. The 401(m) arrangement is not new for the plan year; it is just that the employer chose not to make matching contributions for prior plan years that the 401(m) arrangement was in effect.

Because of the issue presented in the prior **EXAMPLE 4-24**, it may not be advisable to include a discretionary matching contribution formula for a new plan if the employer does not intend to contribute any matching contributions for that first year and it has elected prior year testing. Because the plan authorizes discretionary matching contributions in that first year, the 401(m) arrangement is only new in that year and the deemed 3 percent rule is available only for that year. If no matching contributions are made for the first plan year, the employer has lost the opportunity to use the deemed 3 percent rule. A better approach is to amend the plan to add the matching contribution formula for the first year that the employer wants to make matching contributions.

If the plan uses the current year testing method and it is anticipated that the plan will not be amended to use the prior year testing method merely so that the deemed 3 percent rule can be used in the first year a matching contribution will actually be made, then this issue is not a concern. Plans that use the current year testing method cannot use the deemed 3 percent rule. Furthermore, as a general rule, using the prior year testing method under a plan with a discretionary matching contribution formula is not practical, particularly if there may be wide fluctuations in the level of the match on a year-to-year basis. In that situation, the prior year percentages for the NHCEs in some years will be based on a much lower rate of match than the HCEs are getting in the current plan year.

Successor Plan

The rules for successor plans described above in relation to the deemed 3 percent rule for ADP testing also apply to the ACP test. Thus, the 401(m) arrangement is not considered to be a new plan in the first plan year of a successor plan.

USING QNECS FOR FIRST PLAN YEAR

QNECs may be contributed by the employer and included in the ADP test or ACP test. When the deemed 3 percent rule is used, there is no option to increase the 3 percent by making QNECs. The prior year ADP (or ACP) of the NHCEs is deemed to be 3 percent, and no adjustment of that

deemed percentage is possible. If, under a plan that uses the prior year testing method, the employer wants to make QNECs to boost the ADP (or ACP) limit on the HCEs for the first plan year, the plan must provide that the actual percentages for the NHCEs will be used to run the applicable test for the first plan year.

If You're Curious …

SHORT PLAN YEARS

Some new plans are established with an initial plan year that is less than 12 months long. For example, suppose a company establishes a 401(k) plan with an August 1 effective date, but the first plan year ends December 31, and all subsequent plan years are on the calendar year. The first plan year is the short period from August 1 (the effective date) to December 31. Similarly, a short plan year will occur if the plan is amended to change the plan year.

ADP and ACP Testing in Short Plan Years

Because the ADP test and the ACP test are performed on a plan-year basis, a separate test needs to be run for a short plan year. A short plan year might occur because the effective date of a new plan is not the beginning of a 12-month plan year, or because of an amendment to change the plan year.

When running the ADP test for a short plan year, the elective deferrals credited for the short period are taken into account to determine each eligible employee's ADR. Similarly, when running the ACP test for a short plan year, the matching contributions and after-tax employee contributions credited for the short period are taken into account to determine the employee's ACR.

Prior Year Testing Method

The plan may be using the prior year testing method to determine the ADP (or ACP) of the NHCE group. If the short plan year is the current year, then the percentages of the NHCEs during that year will be used in the ADP (or ACP) test for the next plan year, because the short plan year will be the prior plan year with respect to that next plan year. The ADP (or ACP) for the NHCE group for the short plan year will be based on the prior plan year data, which will be a 12-month plan year (assuming the short plan year is the result of an amendment to the plan year under an existing plan). If the short plan year is the first plan year, either the deemed 3 percent rule or the actual percentages from that first plan year will be used to perform the nondiscrimination test.

Current Year Testing Method

If the plan uses the current year testing method to determine the ADP (or ACP) of the NHCEs, then the NHCEs' percentages for the short plan year would be taken into account in the ADP (or ACP) test for that short year.

EXAMPLE 4-25. Prior Year Testing Method Used for the Short Plan Year. A 401(k) plan has a June 30 plan year end. Effective January 1, 2020, the employer amends the plan year to the calendar year, creating a short plan year from July 1 to

December 31, 2019. A separate ADP test is run for the short plan year ending December 31, 2019.

If the plan is using the prior year testing method for the short plan year, the ADRs for the NHCE group will be based on prior year data (i.e., the plan year running from July 1, 2018, to June 30, 2019). Note that the ADRs for the HCE group are always based on the current year, which is the short plan year ending December 31, 2019 (i.e., July 1 to December 31, 2019). The ADP of the NHCEs determined for the prior plan year will be compared to the ADP of the HCEs for the current plan year to determine if the HCE group passes the ADP test for the short plan year.

EXAMPLE 4-26. Current Year Testing Method Used for the Short Plan Year. Suppose, in the prior **EXAMPLE 4-25**, that the plan uses the current year testing method to determine the ADP of the NHCE group for the short plan year. In that case, the ADP of the NHCE group is based on the data for the short plan year.

EXAMPLE 4-27. Testing in the Plan Year that Follows the Short Plan Year. In EXAMPLE 4-25 and **EXAMPLE 4-26**, the plan year following the short plan year is a 12-month plan year ending December 31, 2020. If the prior year testing method is used, the ADP of the NHCEs will be calculated using the prior year data (i.e., the short plan year from July 1 to December 31, 2019). If the current year method is used, then the ADP of the NHCEs is based on the current year data.

EXAMPLE 4-28. Initial Plan Year is a Short Year. A new 401(k) plan is established with an effective date of September 1, 2019. The plan year ends every December 31, so the first plan year is a short period running from September 1 to December 31, 2019. If the prior year testing method is used for that first plan year, the ADP of the NHCE group may be deemed to be 3 percent, assuming the plan is not a successor plan.

The IRS has not set any minimum length requirements for the initial plan year to use the deemed 3 percent rule under the prior year testing method. Minimum length requirements for the first plan year have been set, for example, in the safe harbor 401(k) plan rules (generally at least three months long), but not for purposes of the deemed 3 percent rule.

Compensation Used for Short Plan Year

Normally, the plan year is the measuring period to determine an employee’s IRC §414(s) compensation. Therefore, if an employee's ADR for a short plan year is being determined, only the employee’s compensation for that short period will be taken into account. However, the “Compensation” definition in Treas. Reg. §1.401(k)-6 permits compensation to be determined for the calendar year ending in the plan year. This allows for a 12-month compensation period to be used to determine deferral percentages. Whatever approach is taken must be applied uniformly to all participants for that plan year.

EXAMPLE 4-29. Amendment Creates Short Plan Year. The plan year of a 401(k) plan is amended from an August 31 year end to a December 31 year end. The short plan year created by the amendment is September 1 to December 31, 2019. Compensation used to determine ADRs for the short plan year may be measured for just the plan year (i.e., September 1 to December 31, 2019) or for the calendar year ending in that plan year (i.e., January 1 to December 31, 2019).

Note that the ADRs of the NHCEs for the short plan year will be used to calculate the ADP of the NHCE group for the next plan year, if the plan uses the prior year testing method. The ADP of the NHCE group for the short plan year, assuming the prior year testing method is used for the short year, will be based on the NHCEs' ADRs for the prior plan year, which was a 12-month period ending August 31, 2019. Because that prior plan year was a 12-month plan year, the compensation period used to determine the NHCEs' ADRs is the same 12-month period (or may be the 2018 calendar year, which is the calendar year ending in such 12-month plan year).

EXAMPLE 4-30. Initial Plan Year is a Short Year. A new 401(k) plan is established with an effective date of April 1, 2019. The plan year ends December 31, so the first plan year is a short period running from April 1 to December 31, 2019, The compensation period used to determine ADRs for the short plan year may be the plan year (i.e., April 1 to December 31, 2019) or the calendar year ending in the plan year (January 1 to December 31, 2019).

If the plan uses the prior year testing method for the first plan year, the ADP of the NHCE group may be deemed to be 3 percent. If the deemed 3 percent rule is used, the elective deferrals and compensation of the NHCEs for the short plan year will only be relevant in running the ADP for the second plan year (i.e., January 1 to December 31, 2020), assuming the prior year testing method is used in that second plan year. If the plan uses the current year testing method to determine the ADP of the NHCE group for the second plan year, the NHCEs' ADRs in the short plan year might never be used in ADP testing.

EXAMPLE 4-31. Noncalendar Plan Year. A new 401(k) plan is established with an effective date of June 1, but a plan year which ends on September 30. The first plan year is a four-month period running from June 1 to September 30. In this case, the compensation for the short plan year will have to be the four-month period that constitutes the plan year. Because there is no calendar year ending in the short plan year (i.e., there is no December 31 between June 1 and September 30), there is no alternative measuring period for compensation permitted under the regulations.

If the employer wants to use a 12-month measuring period for compensation, it should make the plan effective retroactive to the preceding October 1, even though the 401(k) arrangement will only be effective as of June 1. If the plan year is 12 months (i.e., October 1 to September 30), but the period that the 401(k) arrangement is in effect is a short period (i.e., June 1 to September 30), the 12-month plan year may still be used as the measuring period for compensation purposes.

Application of Compensation Dollar Limit

If the compensation period used to calculate ADRs for the short plan year is less than 12 months, the compensation dollar limit must be prorated.[35] For example, for a three-month plan year the applicable compensation dollar limit in effect is prorated to one-fourth of the normal limit.

If a 12-month compensation period is used for the short plan year, then the full dollar limit is used. For example, suppose that for a short plan year running from July 1 to December 31, an employer elects to determine compensation on the basis of the calendar year ending in that short plan year (i.e., January 1 to December 31). The full compensation dollar limit would apply to an employee's compensation for that calendar year period.

When a new 401(k) plan is adopted, there is a tendency for some plan designers to use the date of adoption, or the date elective deferrals will begin, as the first day of the first plan year, creating a short plan year. That raises some of the issues discussed above that can be easily avoided by using a retroactive effective date, and making the first plan year 12 months long. Even though elective deferrals cannot be made before the plan is adopted, the effective date of the plan itself can be retroactive.

EXAMPLE 4-32. Retroactive Plan Effective Date. A company adopts a 401(k) plan on August 15. The employees will be able to start making elective deferrals as of September 1. The plan year ends December 31. The plan is written so that the effective date is retroactive to January 1, making the first plan year 12 months long (January 1 to December 31). The short plan year issues discussed above are not applicable, even though employees can make elective deferrals for only the last four months of the first plan year (i.e., from September 1 to December 31).

4.06: Plan Coverage Changes and Prior Year Testing

Certain plan coverage changes affect the way the prior year testing method is applied. These rules apply equally to the ADP test and the ACP test when the prior year testing method is in effect. If

[35] Treas. Reg. §1.401(a)(17)-1(b)(3)(iii).

the current year testing method is used for the plan year, a plan coverage change does not affect the application of these tests.[36]

PLAN COVERAGE CHANGE DEFINED

A plan coverage change is a change in the group of eligible employees under the 401(k) arrangement or 401(m) arrangement that becomes effective in the testing year (i.e., the current plan year) on account of:

1. the establishment or amendment of a plan that results in employees that were formerly in one plan now eligible for a different plan, or employees being eliminated from participation in any 401(k) plan maintained by the employer;
2. a plan merger or consolidation, or a spin-off from a plan to create a separate plan;
3. a change in the way plans are combined or separated for testing purposes; or
4. any combination of (1), (2) or (3).[37]

An example of (3) would be plans that were not permissively aggregated in the prior year but are in the current year, or vice versa. Another example of (3) would be a plan that disaggregated otherwise excludable employees in the prior plan year, but not in the current year, or vice versa.

CALCULATING THE PRIOR YEAR ADP OR ACP OF THE NHCES IF THERE IS A PLAN COVERAGE CHANGE IN THE TESTING YEAR

If a plan coverage change occurs, and the plan is using the prior year testing method to perform the ADP test (or ACP test), the plan must determine how many prior year subgroups are to be represented in the prior year percentage that is used by the plan. If there are two or more prior year subgroups, the weighted average ADP (or the weighted average ACP) of those prior year subgroups is used as the ADP (or ACP) of the NHCEs.[38]

If You're Curious …

Definition of a Prior Year Subgroup

A prior year subgroup consists of all NHCEs who, in the prior plan year, were eligible employees under another 401(k) arrangement [or 401(m) arrangement, in the case of the ACP test] maintained by the employer and who would have been eligible employees under the plan being tested if the plan coverage change had first been effective on the first day of that prior year.[39]

Exception for Minor Plan Coverage Changes

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[36] Treas. Reg. §1.401(k)-2(c)(4) (ADP testing) and §1.401(m)-2(c)(4) (ACP testing).
[37] Treas. Reg. §1.401(k)-2(c)(4)(iii)(A) and §1.401(m)-2(c)(4)(iii)(A).
[38] Treas. Reg. §1.401(k)-2(c)(4)(i) and §1.401(m)-2(c)(4)(i).
[39] Treas. Reg. §1.401(k)-2(c)(4)(iii)(A) and §1.401(m)-2(c)(4)(iii)(A).

If there are two or more prior year subgroups, and 90 percent or more of the NHCEs are in a single prior year subgroup, the employer may elect to use the ADP and ACP of the plan in which such sub-group was eligible, rather than the weighted averages of the ADP and ACP.[40] For example, suppose two plans are merged in the testing year, and in the prior year plan #1 had 10 eligible employees and plan #2 had 200 eligible employees. Because plan #2 represents at least 90 percent of the NHCEs in the two prior year subgroups, the employer may elect to use the unadjusted prior year ADP and ACP for plan #2 and ignore the prior year ADP and ACP for plan #1. Alternatively, the employer may elect to use the weighted average method described above.

Examples of Prior Year Testing After a Plan Coverage Change

EXAMPLE 4-33. Permissive Aggregation Elected for Current Year but was Not Elected in Prior Year. An employer maintains two 401(k) plans: Plan N covers 300 eligible NHCEs and Plan P covers 100 eligible NHCEs. In the prior plan year, the plans were not permissively aggregated for testing purposes. For the current plan year, the plans are permissively aggregated. This is a plan coverage change because the plans were not permissively aggregated for the prior plan year. The aggregated plans are using the prior year testing method to apply the ADP test so the weighted average ADP for the prior plan year must be determined. Using the prior year data under the two plans, the ADP of the NHCEs is 6 percent under Plan N and 4 percent under Plan P.

Identifying the prior year subgroups. There are two prior year subgroups because there were two separate plans in the prior plan year and those plans were not permissively aggregated in that prior year. The two subgroups are the 300 eligible NHCEs for the prior plan year under Plan N and the 100 eligible NHCEs for the prior plan year under Plan P. In other words, had permissive aggregation of Plans N and P occurred in the prior plan year, rather than in the current plan year, the number of eligible NHCEs in the respective plans would not have changed. However, because the plans were separate in the prior plan year, there are two separate subgroups.

Adjusting the prior year ADPs. The adjusted ADP of the NHCEs for the prior plan year under Plan N is 4.5 percent (i.e., 6% x 300/400 = 6% x 75%), because the number of employees in the Plan N prior year subgroup represents 75 percent of the total number of NHCEs in both prior year subgroups. The adjusted ADP of the NHCEs for the prior plan year under Plan P is 1 percent (i.e., 4% x 100/400 = 4% x 25%), because the number of employees in the Plan P prior year subgroup represents only 25 percent of the total number of NHCEs in both prior year subgroups. These are added together to produce an adjusted prior year ADP of 5.5 percent. By doing the calculation this way, greater weight is given to the ADP for the plan with the largest employee representation among the prior year subgroups (i.e., N plan).[41]

The same computations would apply if the N and P plans were actually merged rather than being permissively aggregated for the current plan year.

Suppose that the plans use the current year testing method for the plan year in which the permissive aggregation election occurs. Now, the fact that the plans were not aggregated

[40] Treas. Reg. §1.401(k)-2(c)(4)(ii) and §1.401(m)-2(c)(4)(ii).
[41] Treas. Reg. §401(k)-2(c)(4)(iv).

in the prior plan year is irrelevant because the prior year data is not being used for the NHCEs. The ADP (or ACP) of the NHCEs would be determined using the current year data under both plans. There is no weighted average calculation because the current year data is treated as if it is all under a single plan because of the permissive aggregation election.

Plan Coverage Changes With Otherwise Excludable Employee Disaggregation and Prior Year Testing

If the employer elects to disaggregate otherwise excludable employees for coverage purposes, which triggers one of the disaggregated testing options for ADP (or ACP) purposes, there is a plan coverage change if the same election was not made in the prior plan year. Similarly, if the employer elects not to disaggregate otherwise excludable employees, there is a plan coverage change if the plan was disaggregating in the prior plan year. Again, this is only an issue for ADP and ACP testing if the prior year testing method is used to calculate the ADP (or ACP) of the NHCEs.

There are four possible scenarios that may apply when otherwise excludable disaggregation is elected and the prior year testing method is being used for ADP or ACP testing purposes. These scenarios are identified below. Each scenario is based on whether statutory employees were disaggregated from otherwise excludable employees for purposes of applying the coverage tests in Year 1 and in Year 2. This is because disaggregation for coverage testing is required for a plan to use a disaggregation testing method for nondiscrimination testing purposes.

For purposes of the discussion below, the prior plan year is designated as Year 1 and the current plan year is designated as Year 2. The Year 1 designation does not mean that the prior plan year is necessarily the first plan year of the plan. These designations just mean that Year 1 immediately precedes Year 2. The discussion of each scenario focuses on the ADP test, but the same rules would apply with respect to the ACP test if the ACP test were being performed under the prior year testing method.

Any references in the discussion to the early participation rule testing option is to the testing option under which otherwise excludable NHCEs are disregarded (and otherwise excludable HCEs are included) in the testing. Any reference in the discussion to the disaggregated plans testing option is to the testing option in the regulations that treats the plan as consisting of two separate plans, one for statutory employees and one for otherwise excludable employees.

Assume the following facts for Year 1:

	Number	**ADP**
Statutory NHCEs	160	4.0%
Otherwise Excludable NHCEs	40	1.0%
All NHCEs	200	3.4%

Scenario #1: Disaggregation in Both Years - No Plan Coverage Change

Suppose coverage-testing disaggregation of otherwise excludable employees is elected in Year 1 and in Year 2. In that case, there has been no plan coverage change, so the ADP test is applied on a disaggregated basis in Year 2.

Early participation rule testing option. The prior year ADP of the NHCEs is based on the Year 1 data for just the eligible statutory NHCEs in Year 1. This is 4 percent in the table above. Also note that the ADP of the HCEs for purposes of the ADP test would

reflect all eligible HCEs in Year 2, whether statutory or otherwise excludable, even though coverage testing has been performed on a disaggregated basis.

Disaggregated plans testing option. The ADP limit for the statutory HCEs would be based on the ADP of the statutory NHCEs for the prior plan year (4 percent in the table above), and the ADP limit for the otherwise excludable HCEs would be based on the ADP of the otherwise excludable NHCEs for the prior plan year (1 percent in the table above).

Scenario #2: No Disaggregation in Either Year—No Plan Coverage Change

Suppose otherwise excludable employees are not disaggregated for coverage testing purposes in either Year 1 nor in Year 2. Like the situation described above, there has been no plan coverage change here. In this case, there is no disaggregation for coverage testing, so there is also no disaggregation rule applied for nondiscrimination testing. When the prior year testing method is used in Year 2, the prior year ADP of the NHCEs is based on the Year 1 data for all eligible NHCEs in Year 1, regardless of whether they were statutory employees or otherwise excludable employees for that year. The prior year ADP is 3.4 percent (see table above).

Scenario #3: Disaggregation in Year 1 But Not in Year 2—Plan Coverage Change

This scenario is a plan coverage change in the same category as when two plans are merged in Year 2, or are permissively aggregated in Year 2 but were not permissively aggregated in Year 1. In Year 2, because there is no coverage-testing disaggregation in effect, the plan may not use the disaggregation method to perform the ADP test for Year 2. Under the prior year testing method, the prior year ADP of the NHCEs is the weighted average of the ADP for the eligible statutory NHCEs in Year 1 and the ADP for the eligible otherwise excludable NHCEs in Year 1. In other words, because there was coverage-testing disaggregation in Year 1, these two groups of NHCEs are treated as two prior year subgroups, as if they were covered by separate plans, so the weighted average calculation applies. To weight the prior year ADPs of the statutory and otherwise excludable NHCEs, the relative numbers of the two groups (160 and 40, respectively) are taken into account.

The prior year ADP of the statutory NHCEs (4 percent) is weighted by a factor of 160/200, resulting in a weighted average of 3.2 percent.

The prior year ADP of the otherwise excludable NHCEs (1 percent) is weighted by a factor of 40/200, resulting in a weighted average of 0.2 percent.

The sum of the two weighted ADPs is 3.4 percent (i.e., 3.2% + 0.2%). Note that this is the same as taking the average of the entire NHCE group, since the weighting is representative of the total number of participants for that prior plan year.

De minimis exception might apply. If at least 90 percent of the NHCEs are in a single prior year subgroup (e.g., at least 90 percent of the prior year's NHCEs are in the statutory group and less than 10 percent are in the otherwise excludable employee group), the plan need not use the weighted average. To illustrate, if in the prior example, the statutory NHCEs in Year 1 represent at least 90 percent of the total number of eligible NHCEs in that year, then the separately calculated ADP for that group could be used in lieu of the weighted average calculated above.

Scenario #4: Disaggregation in Year 2 But Not in Year 1—Plan Coverage Change

This scenario is a plan coverage change in the same category as when one plan is spun-off into two plans, or when previously aggregated plans are no longer permissively aggregated. In Year 2, since coverage-testing disaggregation is in effect, the ADP test must be performed in accordance with one of the disaggregated testing options. However, because there was no disaggregation in Year 1, each disaggregated plan has only one prior year subgroup for that year.

Early participation rule testing option. The prior year ADP of the NHCEs still reflects all eligible NHCEs in Year 1 (i.e., statutory and otherwise excludable), which is 3.4 percent, in spite of there being coverage-testing disaggregation in Year 2. This is because if the disaggregation election were in effect in Year 1, there would be only one prior year subgroup (i.e., the statutory NHCEs), and so a factor of 1 is applied to the 3.4 percent ADP of the NHCEs for Year 1.

Disaggregated plans testing option. Both the ADP limit for the statutory HCEs and the ADP limit for the otherwise excludable HCEs would be based on the same percentage (i.e., the 3.4 percent ADP of the entire group of NHCEs for Year 1). Since coverage disaggregation did not apply in Year 1, the disaggregation of the plans in Year 2 is treated as if a spin-off occurred, where each spin-off plan has only one prior year subgroup. The plan covering statutory employees had one prior year subgroup (i.e., the statutory NHCEs in Year 1) and the plan covering otherwise excludable employees had one prior year subgroup (i.e., the otherwise excludable NHCEs in Year 1). In each case, there is a single prior year subgroup, so the weighted average factor is 1 for both plans, and is applied to the 3.4 percent ADP of the entire group of NHCEs for Year 1.

4.07: Special Coverage Rules in Relation to Acquisitions or Dispositions

TRANSITION PERIOD UNDER IRC §410(B)(6)(C)

A controlled group situation may affect coverage testing. When a company is involved in a merger, acquisition, disposition or spin-off, the make-up of a controlled group or affiliated service group may change. Under a special rule in the Internal Revenue Code (IRC), a plan that satisfies coverage at the time of the acquisition or disposition of a related group member is deemed to meet coverage during a transition period following the transaction.[42] This transition period is sometimes referred to as the IRC §410(b)(6)(C) transition period.

Also, as discussed below, similar treatment is provided with respect to plans in which other business transactions (such as an acquisition of assets) result in the change of employer for one or more individuals. The transition period begins on the date of the change and ends on the last day of the plan year beginning after the change (subject to an earlier ending date in the event of certain post-transaction changes in the plan). The purpose of the transition period is to give the companies

[42] IRC §410(b)(6)(C).

time to evaluate the effect of the demographic changes caused by the transaction, and to modify the plans as necessary to continue to meet coverage requirements.

EXAMPLE 4-34. IRC §410(b)(6)(C) Transition Period. Corporation X purchases the stock of Corporation Y on May 1, 2019. After the purchase, Y is the wholly-owned subsidiary of X. X maintains a profit-sharing plan which, as of May 1, 2019, satisfied coverage. The plan is on a calendar year. The transition period runs from May 1, 2019 (the date of the transaction), through December 31, 2020 (the last day of the plan year that begins after the transaction date), assuming the conditions of IRC §410(b)(6)(C) are satisfied during that entire period. During the IRC §410(b)(6)(C) transition period, the X plan is deemed to meet coverage. This period gives X time to analyze the impact Y employees may have on the plan's ability to meet coverage.

If You're Curious …

Treasury Regulations Expand Application of Transition Rules

The regulations define an acquisition or disposition for IRC §410(b)(6)(C) purposes to include any stock or asset acquisition, merger, or other similar transaction that involves a change in employer of the employees of a trade or business.[43] This definition permits use of this transition period if a corporation purchases the assets of another company and acquires the employees of that company. Following the purchase of the assets, the ownership of the selling company has not changed; it still exists as a separate entity, and does not become a part of a new controlled group. Yet, the regulations permit use of the transition period under this type of transaction for both the buyer's and the seller's plans.

Termination of Transition Period Upon Subsequent "Significant" Change in the Plan

One of the more problematic issues with respect to determining if the IRC §410(b)(6)(C) transition period applies is that there can be no significant change in coverage under the plan during the transition period other than a change directly resulting from the acquisition or disposition.[44] For example, an amendment during the transition period to exclude hourly paid employees would violate this rule because the exclusion of hourly paid employees is not directly related to the acquisition or disposition. The Treasury regulations and the IRS interpret the prohibition on significant changes to the coverage of the plan to include changes to plan benefits provided under the plan, and it only takes a relatively low level of significance that must be achieved before the transition period is deemed to have ended. In fact, the IRS guidance appears to require very little modification to be considered to be significant, particularly if the benefit formula is modified. Therefore, any change of substance to the plan could be considered by the IRS as an event terminating the transition period.[45] Informal statements by IRS officials at conferences indicate that the cyclical restatement of the plan to conform to legal changes does not necessarily constitute a significant change, if all that is modified in the plan

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[43] Treas. Reg. §1.410(b)-2(f).
[44] IRC §410(b)(6)(C)(i)(II).
[45] Rev. Rul. 2004-11.

provisions are the required modifications. However, the required restatement process is often a time when the plan sponsor reexamines the plan terms and makes changes. Therefore, it is common that the restatement will terminate the transition period.

Significant Change Results in Prospective Loss of Transition Rule

If a significant change is made to the plan, the plan loses reliance on the transition period. That loss of the transition period is prospective. Thus, the plan is deemed to meet the coverage requirements from the beginning of the transition period until the effective date of the significant change.[46] Furthermore, the significant change is plan-specific; a change in one plan and a concurrent termination of the transition period does not affect another plan of the same sponsor that has not been modified.

No Relief From Nondiscrimination Testing From IRC §410(b)(6)(C)

The transition rule only deems the plan to satisfy coverage, not the applicable nondiscrimination tests.[47]

Creation of New Subsidiary

The transition relief granted by IRC §410(b)(6)(C) appears to contemplate some form of acquisition from an unrelated entity. The formation of a new subsidiary by a company as part of a business restructuring or an acquisition involving entities that are already part of a related group are probably not covered by the transition rule.

The reason why the rules are interpreted this way is that the situation is analogous to the hiring of new employees within the same company. If a company simply decided to expand its business operations and hired new employees, but did not create a separate subsidiary to conduct the expanded business operations, the transition rule clearly would be inapplicable. Simply creating a separate business that will be part of the controlled group of the company that created that business, is a form over substance modification that does not change the result for coverage testing purposes.

Reliance on Transition Rule Is Optional

The transition rule under IRC §410(b)(6)(C) is optional. The plan sponsor may, instead, elect to apply the coverage tests during this transition period.[48] Why might an employer elect to apply the coverage tests? One example would be where the employer is unclear whether the plan qualifies for the transition period, and has decided not to seek a determination letter on the issue. By performing coverage testing anyway, and demonstrating that the plan passes, there is a back-up position in the event the IRS challenges the plan's reliance on the transition rule.

One issue that will arise if the employer chooses to do coverage testing is how to identify excludable employees. Here, the manner in which the business transaction has occurred might be instructive.

Asset Acquisitions

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[46] Id.
[47] See, Rev. Rul. 2004-11.
[48] Rev. Rul. 2004-11.

If a company purchases the assets of another business, and acquires employees in connection with that purchase, the acquired employees' prior service with the selling business is not required to be credited by the purchasing company, unless the purchaser is taking over the plan (or portion of the plan) that covered those acquired employees.[49] If the purchaser does not have to recognize the prior service, the purchaser may treat the acquired employees as new employees.[50] If the acquired employees are treated as new employees by the purchaser, they might not satisfy the eligibility service requirement under the purchaser's plan, rendering them excludable employees under the coverage rules.[51]

Stock Acquisitions

If the transaction involves a stock acquisition (or acquisition of nonstock equity interests, such as partnership interests), the company being acquired continues to exist, so service prior to the acquisition generally is counted in determining whether employees are excludable employees for coverage testing purposes. However, even in a stock acquisition, if the acquisition involves the acquisition of the subsidiary corporation of an unrelated parent company, and the acquiring parent company does not take over the plan maintained by the subsidiary (or its prior parent company), the employees of the subsidiary also are treated as having severed from employment from one controlled group and, thus, are new employees of the acquiring company (i.e., the post-acquisition controlled group).[52]

In such a case, the subsidiary employees' pre-acquisition service may be disregarded, and the individuals might be excludable employees for coverage testing purposes. If this exception does not apply, generally the employees of the acquired company will be taken into account for coverage testing, at least to the extent their pre-acquisition service qualifies them under the eligibility service requirements for the plan being tested and they are not excludable employees for some other reason (e.g., they are not union employees).

If a new controlled group or affiliated service group results from the acquisition of ownership of an entity, there may be another issue regarding the identification of excludable employees. This would arise when the companies within the new controlled group have separate plans. Specifically, each company would take into account service with new related group members only to the extent the service is earned after the formation of the new related group on account of the business transaction.

EXAMPLE 4-35. Crediting Service with Newly Acquired Brother-Sister Corporation. Corporation Z is owned 40 percent by Adam, 40 percent by Barbara and 20 percent by Carmine. Corporation W is owned 50 percent by David and 50 percent by Ellie. On May 1, 2019, a deal is worked out where Adam and Barbara purchase all of the stock of W. Thus, as of the May 1 acquisition date, Corporation Z and Corporation W are brother-sister corporations under the controlled group rules under IRC §414(b). [Controlled group rules are covered in more detail in *The ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics.*]

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[49] IRC §414(a).
[50] See, GCM 39824.
[51] Treas. Reg. §1.410(b)-6.
[52] Notice 2002-4 and GCM 39824.

Summary of Ownership Interests

Owners	Corp Z	Corp W (before sale	Corp W (after sale
Adam	40%		50%
Barbara	40%		50%
Carmine	20%		
David		50%	
Ellie	50%		

Both corporations sponsor plans that have a December 31 plan year end. After the acquisition the companies continue to maintain separate plans. When Corporation Z determines the coverage testing group, it only counts employees of Corporation W who have satisfied the Corporation Z plan's eligibility service requirement, taking into account all service with Corporation Z, but service with Corporation W only after the May 1 acquisition date. This is because, before May 1, Corporation W and Corporation Z were not part of a controlled group.

Therefore, service with Corporation W would be with a different employer for purposes of Corporation Z and the Corporation Z plan. Consistent with this approach, the Corporation W plan would determine the coverage testing group by taking into account all service with Corporation W, but only post-acquisition service with Corporation Z.

This approach apparently would not work if Corporation W and Corporation Z adopted a single plan, or if the Corporation W and Corporation Z plans are merged, because that plan would have to count all service with either sponsoring employer.

4.08: Review of Key Concepts

- What are the double-counting limits?
- Under what circumstances may the double-counting limits apply to a plan?
- Describe the mandatory aggregation rule for HCEs.
- When may plans be permissively aggregated for coverage testing and what consequences does this have for nondiscrimination purposes?
- Give some examples of disaggregation.
- How are plans with only HCEs or only NHCEs affected by coverage and nondiscrimination requirements?
- Describe the permissive disaggregation rules applicable to otherwise excludable employees.
- What are the two testing options for testing otherwise excludable employees for nondiscrimination purposes?
- Explain the difference between the early participant rule and the disaggregated plans testing method.
- What is the deemed 3 percent rule and how does it apply to ADP and ACP testing?
- Explain the successor plan rule.
- What effect does a plan coverage change have on prior year ADP and ACP testing?
- What is the IRC §410(b)(6)(C) transition period?

4.09: For Practice – True or False

1. Double-counting limits may apply to a plan switching from prior year testing to current year testing.
2. Elective deferral amounts for an HCE who participates in more than one plan of the same employer are combined and used in each plan's ADP test.
3. The IRC §410(b)(6)(C) transition period will begin on the date of the change and extend through the end of the plan year beginning after the change.
4. Plans that are aggregated for coverage testing do not have to be aggregated for nondiscrimination testing.
5. The IRC §410(b)(6)(C) transition period rules deem a plan to satisfy coverage and nondiscrimination requirements during the period of transition.
6. Union and nonunion plans may be permissively aggregated for coverage and nondiscrimination requirements.
7. Only plans that make QNECs may be affected by the double-counting limits.
8. The statutory employees and the otherwise excludable employees may be disaggregated when testing the 401(k) component of a plan for coverage and nondiscrimination purposes.
9. A plan that benefits only NHCEs automatically satisfies nondiscrimination requirements.
10. A new 401(k) plan using prior year testing may deem the prior year NHCE ADP to be 3 percent or may use actual NHCE data in the first year of the plan for testing purposes.

4.10: Sample Test Questions

1. All of the following statements regarding aggregation and disaggregation of 401(k) plans are TRUE, EXCEPT:

   A. Plans that are permissively aggregated must use the same testing methodology, either prior year or current year.
   B. Plans that are aggregated to satisfy coverage requirements must be aggregated for ADP testing.
   C. The union and nonunion portions of a plan are subject to mandatory disaggregation.
   D. Statutory employees may be disaggregated from otherwise excludable employees for ADP testing.
   E. Plans that are permissively aggregated need not have the same plan year.

2. All of the following statements regarding double-counting limits are TRUE, EXCEPT:

   A. A plan switching from current year testing to prior year testing may have to consider the double-counting limits rules.
   B. QNECs used to satisfy current year ADP testing performed last year are not included in the prior year testing performed this year.
   C. QNECs used to satisfy current year ACP testing performed last year are not included in the prior year testing performed this year.
   D. QMACs used to satisfy current year ACP testing performed last year are not included in the prior year testing performed this year.

E. A plan switching from prior year testing to current year testing will not be affected by the double-counting limits rules.

3. All of the following statements regarding the deemed 3 percent rule are TRUE, EXCEPT:

A. A new plan using prior year testing may use an NHCE ADP and/or ACP of 3 percent in the first year.
B. A successor plan to a prior 401(k) plan may use the deemed 3 percent rule.
C. A new plan using current year testing may not use the deemed 3 percent rule.
D. A new plan using prior year testing may use the actual NHCE ADP and/or ACP for the first year.
E. An existing profit-sharing plan that adds a 401(k) feature is treated as a new plan for purposes of the deemed 3 percent rule.

4. Which of the following statements regarding the 401(k) plan disaggregation rules is/are TRUE?

I. The disaggregated plans testing method treats otherwise excludable employees and statutory employees as if each group participates in a separate plan.
II. If the disaggregated plans testing method is used for ADP/ACP testing, a separate ADP/ ACP test must be performed for each disaggregated group.
III. A safe harbor 401(k) plan may not be designed to exclude the otherwise excludable employees from the safe harbor provisions.

B. I only
C. III only
D. I and II only
E. II and III only
F. I, II and III

5. Which of the following statements regarding the early participation rule is/are TRUE?

I. The early participation rule election is sometimes referred to as the "carve-out" method.
II. The early participation rule permits the plan to exclude all HCEs who have not met one year of service and age 21 requirements from the ADP and ACP tests.
III. If the early participation rule is used for ADP/ACP testing, a separate ADP/ACP test must be performed for each disaggregated group.

B. I only
C. II only
D. I and III only
E. II and III only
F. I, II and III

6. Which of the following statements regarding 401(k) plan aggregation and disaggregation rules is/ are TRUE?

I. Otherwise excludable NHCEs may be disregarded for ADP testing.
II. Otherwise excludable NHCEs may be disregarded for ACP testing.

III. Plans that are permissively disaggregated to satisfy ACP testing must also be disaggregated for 401(m) coverage testing.

B. I only
C. II only
D. I and III only
E. II and III only
F. I, II and III

7. Which of the following statements regarding double-counting limits is/are TRUE?

I. Double-counting limits may apply to a plan that uses shifting techniques to satisfy ACP testing.
II. Double-counting limits may apply in the first year of a new plan.
III. If the double-counting limits apply, the NHCE data is used twice, during the prior year and the current year.

B. I only
C. II only
D. I and III only
E. II and III only
F. I, II and III

8. All of the following statements regarding the deemed 3 percent rule are TRUE, EXCEPT:

A. An existing profit-sharing plan that adds a 401(m) feature is treated as a new plan for purposes of the deemed 3 percent rule and the ACP test.
B. An existing plan with a previously unused 401(m) arrangement may use the deemed 3 percent rule for the first year it decides to make matching contributions .
C. The HCE ADP can be as high as 5 percent and the plan will still satisfy the ADP test when the deemed three percent rule is in effect.
D. The HCE ACP can be as high as 5 percent and the plan will still satisfy the ACP test when the deemed three percent rule is in effect.
E. The deemed three percent rule must be stated in the plan document.

9. Which of the following statements regarding election to use the early participation rule for plans covering otherwise excludable employees is/are TRUE?

I. The election requires that two ADP/ACP tests be performed, one for all HCEs and one for the otherwise excludable HCEs.
II. The election permits the plan to exclude all NHCEs who have not met one-year of service and/or age 21 requirements from the ADP and ACP tests.
III. The election is permitted only if the employer uses the otherwise excludable employee rule for coverage testing.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

4.11: Solutions to True or False Questions

1. False. Double-counting limits will apply if a plan is switching from current year testing to prior year testing.
2. True.
3. True.
4. False. Plans that are aggregated for coverage must be aggregated for nondiscrimination purposes.
5. False. The IRC §410(b)(6)(C) transition period is only a grace period for coverage rules, not for nondiscrimination testing under IRC §401(a)(4).
6. False. Union and nonunion plans must be mandatorily disaggregated for coverage and nondiscrimination purposes.
7. True.
8. True.
9. True.
10. True.

4.12: Solutions to Sample Test Questions

1. The answer is **E**. Plans that are permissively aggregated must have the same plan year.
2. The answer is **D**. The double-counting limits only prohibit considering QNECs in prior year testing that were used to satisfy nondiscrimination testing in the prior year. QMACs are not subject to the double-counting rules.
3. The answer is **B**. A plan may not use the 3 percent rule if it is a successor plan to a prior 401(k) plan.
4. The answer is **C**. A safe harbor 401(k) plan may be designed to exclude the otherwise excludable employees from the safe harbor provisions.
5. The answer is **A**. HCEs who have not met one year of service and age 21 requirements are not excluded from the ADP and ACP tests under the early participation rule. Under the early participation rule, a single ADP test and a single ACP test (if applicable) is performed taking into account all statutory employees and only those otherwise excludable employees who are HCEs. The otherwise excludable NHCEs are left out of the ADP and ACP tests entirely.
6. The answer is **E**. All of the statements are true.
7. The answer is **C**. The double-counting limits apply only after there is a switch from using the current year testing method in one plan year to the prior year testing method in the next plan year. Thus, double-counting limits will never apply to the first year of a new plan.
8. The answer is **B**. An existing plan with a previously unused 401(m) arrangement may not use the deemed 3 percent rule for the first year it decides to make matching contributions. If no matching contributions are made for the first plan year, the employer has lost the opportunity to use the deemed 3 percent rule.
9. The answer is **D**. Under the early participation rule, a single ADP test (and a single ACP test, if applicable) is performed. The test excludes all otherwise excludable NHCEs (i.e.,

those who have not met one year of service and age 21 requirements) and includes all HCEs (both statutory employees and otherwise excludable HCEs).

CHAPTER 5:

SAFE HARBOR 401(K) AND 401(M) PLANS

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5.01: Key Terms

- 401(k)(12) safe harbor
- 401(k)(13) safe harbor
- ACP safe harbor
- ADP safe harbor
- Basic formula
- Eligible automatic contribution arrangement (EACA)
- Enhanced formula
- Initial automatic enrollment date
- Qualified automatic contribution arrangement (QACA)
- QACA safe harbor
- Safe harbor 401(k) plan
- Safe harbor matching contribution
- Safe harbor nonelective contribution
- Wait-and-see approach

5.02: Introduction

Safe harbor 401(k) plans are like traditional 401(k) plans, but they offer advantages to plans that are at risk of failing the non-discrimination tests. Internal Revenue Code (IRC) §401(k)(12) provides that if a 401(k) plan satisfies the conditions in that section, the ADP test is deemed satisfied. IRC §401(k)(13) offers an alternative safe harbor, but it is available only to plans that have a specific type of automatic enrollment feature that satisfies the conditions to be a qualified automatic contribution arrangement (QACA).

5.03: Prerequisites for Using the Safe Harbor 401(k) Plan Design

401(K)(12) SAFE HARBOR

For a plan to use the 401(k)(12) safe harbor (i.e., the "normal" 401(k) safe harbor), the plan must be a qualified plan that includes a qualified cash or deferred arrangement under IRC §401(k). Special rules apply for 403(b) plans, which are discussed later in this chapter.

Any of the following features may be included in a 401(k) plan without jeopardizing the plan's eligibility to use the 401(k)(12) safe harbor, if designed properly:

1. automatic enrollment;
2. catch-up contributions;
3. designated Roth contributions;
4. discretionary employer nonelective contributions, including those that are designed under a new comparability formula; and
5. discretionary matching contributions.

A plan using the 401(k)(12) safe harbor may include an automatic enrollment feature, but it is not required to do so. If the plan opts to include an automatic enrollment feature, it does not have to satisfy the definition of a QACA.

401(K)(13) SAFE HARBOR

To rely on the ADP safe harbor under IRC §401(k)(13) (i.e., the QACA safe harbor), the prerequisites described above for the 401(k)(12) safe harbor apply and the plan must also include an automatic enrollment feature that satisfies the definition of a QACA.

The optional features described above for a 401(k)(12) safe harbor are also permissible for a 401(k)(13) safe harbor plan.

QUALIFIED AUTOMATIC CONTRIBUTION ARRANGEMENT

A **qualified automatic contribution arrangement** (QACA) is an **automatic contribution arrangement** (ACA) whereby the automatic enrollment feature meets certain minimum requirements and the plan also satisfies the safe harbor 401(k) plan requirements. The advantages of meeting the QACA definition are:

- to qualify for a waiver of the ADP and/or ACP tests;
- to qualify for an exception to compliance with top-heavy rules;
- to use an automatic contribution arrangement and to require a higher level of elective contributions to qualify for the maximum match than is needed in a traditional safe harbor plan (thereby encouraging higher employee contributions); and
- to be permitted to use a vesting schedule with safe harbor contributions.

A QACA may meet the requirements of an eligible automatic contribution arrangement (EACA), but is not required to do so.

The following table identifies the main issues with respect to automatic enrollment arrangements and how they differ.

Issue	ACA	EACA	QACA
(1) Employee defaulted into elective deferral arrangement in absence of an affirmative election	Yes	Yes	Yes
(2) Automatic enrollment arrangement applies to already-eligible employees	Optional	Optional, but see (8) below	Required, unless employee made affirmative election
(3) Default enrollment rate satisfies uniformity test	Yes	Yes	Yes
(4) Maximum limit on default enrollment percentage	No	No	10%
(5) Minimum default enrollment percentage	No	No	3%
(6) Automatic escalation of default enrollment rate	Optional	Optional	Required, per IRC §401(k)(13)

Issue	ACA	EACA	QACA
(7) Permissible withdrawals allowed by employees who are auto-enrolled	No, unless also designed as an EACA	Yes	No, unless also designed as an EACA
(8) 6 months to correct ADP/ACP test without excise tax under IRC §4979	No	Yes, if all eligible employees are covered by EACA	N/A because plan is not subject to ADP test
(9) ADP test waived	No, unless also designed as an IRC §401(k)(12) safe harbor plan	No, unless also designed as an IRC §401(k)(12) safe harbor plan	Yes
(10) QDIA required	Yes	Optional	Optional
(11) Annual notice requirement	Yes	Yes	Yes
(12) Timing of notice	Reasonable period (may use QACA safe harbor period)	Reasonable period (may use QACA safe harbor period)	Reasonable period (Regulations define safe harbor period)

Automatic Deferral Requirements

Unlike an ACA or EACA that has no minimum or maximum required automatic enrollment percentage, the automatic elective contribution percentage under a QACA initially must be between 3 percent and 10 percent of compensation. The initial percentage must be no less than the following minimum percentage requirements:

a. 3 percent for the period beginning on the date that the first automatic elective contribution is made on the participant's behalf (**initial automatic enrollment** date) and ending on the last day of the first plan year that begins after the initial automatic enrollment date;
b. 4 percent during the first plan year following the period described in (1);
c. 5 percent during the second plan year following the period described in (1); and
d. percent during any subsequent plan year.

If the initial automatic enrollment percentage is 6 percent or more, this meets the required level of automatic enrollment for all years for a participant. As noted earlier, the maximum level of automatic enrollment under a QACA is 10 percent.

EXAMPLE 5-1. Automatic Increases. If the plan year is the calendar year and a participant's initial automatic enrollment date is August 1, 2019, the 3 percent minimum rate could apply for the period August 1, 2019, through December 31, 2020, but then would have to increase to at least 4 percent for 2021, at least 5 percent for 2022 and at least 6 percent for 2023 and subsequent years, not to exceed 10 percent.

The minimum automatic deferral rates described above apply only so long as the employee's participation in the arrangement is due to the automatic enrollment feature. At any time that the employee makes an affirmative election not to have more contributions made, or to have contributions

made at a specified level, the automatic enrollment election ceases to exist and further increases in the employee's rate are solely up to that employee.

The automatic enrollment feature under a QACA need not apply to any employee who was eligible for the plan prior to the date that the arrangement becomes a QACA, but only if such employee has an affirmative election in effect – even if such affirmative election was not to defer anything. Note that the relevant date here is the effective date of the QACA under the plan. It is not relevant whether the plan contained an automatic enrollment feature before the effective date of the QACA. The plan could also apply the automatic enrollment feature to already-eligible participants who made an affirmative deferral election, but it is not required to do so to be a QACA.

5.04: ADP Safe Harbor

To qualify for the ADP safe harbor, the 401(k) plan must satisfy the following conditions:

1. a safe harbor contribution requirement;
2. a vesting requirement;
3. withdrawal restrictions; and
4. an annual notice requirement.

If the safe harbor 401(k) plan includes a matching contribution formula, the matching contributions may or may not be subject to the ACP test, depending on the structure of the formula. This issue is discussed later in this chapter.

The rules governing safe harbor 401(k) plans were outlined in the final Treasury regulations issued in December 2004, modified for the addition of new 401(k) rules under the Pension Protection Act of 2006 (PPA).[1]

Catch-up contributions are also available in safe harbor 401(k) plans. The catch-up limit is the same as for a regular 401(k) plan (e.g., $6,500 for 2020 . Catch-up contributions are easier to administer in safe harbor plans because there is no ADP test to perform. Thus, there is no possibility that elective deferrals may need to be refunded, due to a failure of the ADP test that results in a possible recharacterization of elective contributions as catch-up contributions under the ADP limit.[2]

CONTRIBUTION REQUIREMENT

The employer must make either a safe harbor matching contribution or a safe harbor nonelective contribution to satisfy the ADP safe harbor contribution requirement.[3] The employer is permitted to make both, but must satisfy only one of these requirements to eliminate the ADP test. The

[1] Treas. Reg. §1.401(k)-3 (ADP safe harbor) and Treas. Reg. §1.401(m)-3 (ACP safe harbor).
[2] Treas. Reg. §1.414(v)-1(d)(2).
[3] IRC §401(k)(12)(A)(i).

safe harbor contribution must be made on behalf of all eligible NHCEs. The plan may, but is not required to, provide the safe harbor contribution to the eligible HCEs.

Safe Harbor Matching Contribution

A **safe harbor matching contribution** will satisfy the ADP safe harbor contribution requirement if it is no less than the contribution determined under the basic formula described in IRC §401(k)(12)(B), or under an enhanced formula.

Basic Formula under 401(k)(12) Safe Harbor

The **basic formula** provides the following match:

100 percent match on the first 3 percent of compensation deferred;
+
50 percent match on the next 2 percent of compensation deferred.

EXAMPLE 5-2. Basic Formula. Paul and Rhonda are participants in a safe harbor 401(k) plan that provides the basic match to satisfy the ADP safe harbor. Each participant's compensation for the plan year is $40,000. Paul defers 2 percent of compensation, or $800, and Rhonda defers 4 percent of compensation, or $1,600.

Paul's match is $800, because the first 3 percent deferred is matched dollar-for-dollar and Paul's deferral rate is 2 percent. Rhonda's match is $1,400. For Rhonda, the first 3 percent deferred ($1,200) is matched dollar-for-dollar, but the next 1 percent she deferred ($400) is matched only 50-cents-on-the-dollar, for an additional match of $200 on that portion of her elective contributions.

The maximum match that is required under the basic formula is 4 percent of compensation (100 percent of elective contributions up to 3 percent of compensation, plus 50 percent of elective contributions between 3 and 5 percent of compensation). A match of that amount would apply to any participant who defers at least 5 percent of compensation.

Enhanced Formula under 401(k)(12) Safe Harbor

An **enhanced formula**—that is, a matching formula that provides a greater match than the basic match formula at any level of deferral—satisfies the ADP safe harbor contribution requirement.[4] To test whether a formula is an enhanced formula, look to the level of match that is made on each level of deferral up to 5 percent of compensation, and compare the matching contribution under the enhanced formula with the matching contribution that would be made at that deferral level under the basic formula.

EXAMPLE 5-3. Enhanced Formula. The matching formula under a safe harbor 401(k) plan is 100 percent match on the first 4 percent of compensation deferred,

[4] IRC §401(k)(12)(B)(iii), Treas. Reg. §1.401(k)-3(c)(3).

with no additional match on higher levels of deferral. This formula satisfies the enhanced formula requirement, and thus, the ADP safe harbor contribution requirement, because the match is no less valuable than the basic formula. If this formula were in effect in the plan described in **EXAMPLE 5-2**, Paul's match would be the same ($800), but Rhonda's match would be $1,600 rather than $1,400.

EXAMPLE 5-4. Enhanced Formula. The matching formula under a safe harbor 401(k) plan is 150 percent of the first 3 percent deferred. This, too, satisfies the enhanced formula requirement and thus, the ADP safe harbor contribution requirement. If this formula were in effect in the plan described in **EXAMPLE 5-2**, Paul's match would be $1,200 and Rhonda's match would be $1,800.

In Paul's case, his entire elective contribution amount is multiplied by 150 percent because his deferral rate is less than 3 percent. In Rhonda's case, only the first 3 percent deferred ($1,200) is subject to the match, but it is multiplied by 150 percent under this formula. In each case, the match is greater than the match that would be available under the basic formula, as shown in **EXAMPLE 5-2**.

Note that the elective contributions that are matched under the enhanced formula do not have to be limited to a certain percentage of compensation to satisfy the ADP safe harbor contribution requirement. As we will see later, if the formula matches contributions in excess of 6 percent of compensation, it may satisfy the ADP safe harbor but the matching contributions will not satisfy the ACP safe harbor.

In addition to providing a greater match than the basic formula, an enhanced formula may not provide a higher level of match for any HCE than is provided for any NHCE who contributes at the same deferral rate as the HCE.[5] Another requirement is that the rate of match cannot increase as the rate of deferral increases.[6]

EXAMPLE 5-5. Different Matching Contribution Formulas for Different Job Classifications. A plan provides a matching contribution formula that equals 100 percent of the first 4 percent of compensation deferred by hourly paid employees, and 100 percent of the first 6 percent of compensation deferred by salaried employees. Although each formula provides a match that is no less than the match under the basic formula, the matching contribution does not satisfy the ADP safe harbor contribution requirement. A salaried HCE is eligible for a 100 percent match on a 6 percent rate of deferral, whereas an hourly paid NHCE who

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[5] IRC §401(k)(12)(B)(ii), Treas. Reg. §1.401(k)-3(c)(4).
[6] IRC §401(k)(12)(B)(iii), Treas. Reg. §1.401(k)-3(c)(3).

defers 6 percent of compensation is only eligible for a 100 percent match on the first 4 percent deferred.[7]

Although the formula in **EXAMPLE 5-5** does not satisfy the requirements of an enhanced formula under the ADP safe harbor, it does not necessarily make the matching contribution discriminatory. It just means that the matching contribution cannot be used to qualify the 401(k) plan as a safe harbor under the ADP test. If the plan satisfies the nonelective safe harbor contribution requirement, the ADP test may still be avoided. However, even if the ADP safe harbor is met through the safe harbor nonelective contributions, the match described in this example will not be eligible for the ACP safe harbor, so an ACP test will be required in this plan, regardless of whether the ADP safe harbor is satisfied.

EXAMPLE 5-6. Tiered Matching Formula. A plan provides a matching contribution formula that equals 100 percent of the first 3 percent of compensation deferred, plus 150 percent of the next 2 percent of compensation deferred. Although this formula produces a matching contribution that is at least as valuable as the matching contribution under the basic formula, it does not satisfy the conditions for an enhanced formula under the ADP safe harbor contribution requirement because it provides a higher rate of match (150 percent) at higher rates of deferral (elective contributions above 3 percent of compensation).

In summary, therefore, matching contributions will fall into one of three categories:

1. Contributions that satisfy the basic match or enhanced match rules, so that they can be used as ADP safe harbors and avoid the ADP testing;
2. Contributions that do not satisfy the rules for a basic or enhanced match, but do satisfy the rules for an ACP safe harbor (which will be discussed below), and so can be used to avoid ACP testing; or
3. Contributions that satisfy neither the ADP nor ACP safe harbors and are subject to ACP testing (even if the ADP safe harbor is being fulfilled by a 3 percent nonelective contribution).

Basic Formula under the QACA [401(k)(13)] Safe Harbor

The basic formula for a QACA provides the following match:

100 percent match on the first 1 percent of compensation deferred;

+

50 percent match on the next 5 percent of compensation deferred.

Thus, the maximum required match is 3.5 percent of compensation and is spread out over elective contributions equaling 6 percent of compensation. Compare this to the safe harbor matching formula under the 401(k)(12) safe harbor, which provides for a maximum match of 4 percent of compensation. This reflects Congress' objective of encouraging automatic enrollment features,

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[7] Treas. Reg. §1.401(k)-3(c)(7), Example 5.

which have proven to increase employee savings rates, by offering a less expensive contribution alternative under the QACA rules.

EXAMPLE 5-7. Basic Formula. Assume that Paul and Rhonda are participants in a plan designed to meet the QACA safe harbor. Each employee's compensation for the plan year is $40,000. Paul defers 2 percent of compensation, or $800, and Rhonda defers 4 percent of compensation, or $1,600.

Paul's match is $600, because the first 1 percent of Paul's compensation deferred ($400) is matched at a rate of 100%, and the next 1 percent of Paul's compensation deferred ($400) is matched at a rate of 50 percent ($200). Rhonda's match is $1,000. For Rhonda, the first 1 percent of compensation deferred ($400) is matched dollar-for-dollar, but the next 3 percent of compensation she deferred ($1,200) is matched at a rate of 50 percent, for an additional match of $600.

Compare these contributions to those in the non-QACA safe harbor in **EXAMPLE 5-2**. Both participants in this example receive a lesser match than under the normal safe harbor ($800 for Paul and $1,400 for Rhonda).

Enhanced Formula Under the QACA Safe Harbor

Similar to the 401(k)(12) safe harbor requirements, the QACA safe harbor requirements allow for an enhanced matching formula that provides for a match that is no less than the matching contribution an employee would receive under the basic formula at any rate of deferral.

EXAMPLE 5-8. Flat Rate Match Satisfying QACA Safe Harbor. The matching formula under a safe harbor 401(k) plan is 100 percent match on the first 3.5 percent of compensation deferred, with no additional match on higher levels of deferral. This formula satisfies the enhanced formula requirement because the match is no less valuable than the basic formula. If this formula were in effect in the plan described in EXAMPLE 5-7, Paul's match would be $800, instead of $600, because he deferred 2 percent of compensation ($800) which is matched 100 percent under this formula. Rhonda's match would be $1,400 rather than $1,000 because she deferred 4 percent of compensation and the first 3.5 percent ($1,400) is matched 100 percent under this formula.

Matching of After-tax Employee Contributions

Some plans offer a matching contribution on both elective contributions under the 401(k) arrangement and after-tax employee contributions. The plan may still satisfy the ADP safe harbor (or the ACP safe harbor) with respect to matching contributions even though both types of contributions are matched.[8] (It is important to note that, even if all matching contributions satisfy

[8] Treas. Reg. §1.401(k)-3(c)(5)(i).

the ADP or ACP safe harbor, the plan would still be subject to the ACP test, at least in relation to the after-tax employee contributions.)

The ADP safe harbor is satisfied in a plan that is matching after-tax employee contributions only if:

10. the amount of an employer's match made with respect to the employee's elective contributions is not affected by the amount of the employee's after-tax contributions (i.e., a separate matching formula is provided for each type of contribution), or
11. the matching contributions made on the sum of the employee's elective contributions and after-tax employee contributions are made under the same terms as matching contributions are made with respect to elective contributions alone.

EXAMPLE 5-9. Matching After-tax Employee Contributions. A 401(k)(12) safe harbor plan provides a matching contribution equal to 100 percent of the first 4 percent contributed. The sum of an employee's elective contributions and after-tax employee contributions is taken into account to reach the 4 percent level. The matching contribution formula does not fail to satisfy the ADP or ACP safe harbor. This is true even though an employee first makes after-tax employee contributions for the plan year and, as a result, some of his or her elective contributions for the plan year are unmatched because the maximum match is reached first with respect to the employee's after-tax employee contributions.

Matching of Catch-up Contributions

A safe harbor plan may not preclude safe harbor matching contributions on catch-up contributions. The Treasury has determined that it would be a violation of the safe harbor rules if the plan provided that a safe harbor match would not be made with respect to elective contributions that are treated as catch-up contributions. [9] Furthermore, applying the safe harbor matching contribution formula to catch-up contributions does not cause the plan to fail to provide a uniform matching contribution formula, even though catch-up contributions are permitted to be made only by participants who have reached age 50 (or will reach 50 by the end of the calendar year in which the catch-up contributions are made), and HCEs who are over age 50 have a potential to earn a greater dollar amount of matching contributions than NHCEs who are under age 50.[10] An employee is not treated as having a different rate of match merely because an otherwise nondiscriminatory matching formula results in a matching contribution on catch-up contributions.

EXAMPLE 5-10. Matching Catch-up Contributions. A plan's safe harbor matching formula is an enhanced formula equal to 100 percent of the first 6 percent deferred and the plan provides the safe harbor match to both HCEs and NHCEs. The plan has immediate eligibility.

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[9] See, the preamble to the December 29, 2004, regulations, 69. F.R. 78151 (middle column).

[10] Treas. Reg. §1.414(v)-1(d)(4).

For 2020, one of the newly hired employees has compensation of $200,000 for that year. This employee is an NHCE, because he had no compensation from the employer in the lookback year and is not a 5 percent owner of the employer, as determined under the HCE definition under IRC §414(q). This employee is age 45. An HCE under the plan also earns $200,000 and is age 52.

For 2020, the NHCE's deferral limit is $19,500, which is only 9.75 percent of compensation, because that is the IRC §402(g) limit for the year and the NHCE is not catch-up eligible. However, the HCE may defer up to $26,000, which is 13.0 percent of compensation, because he is catch-up eligible and, thus, may exceed the IRC §402(g) limit by $6,500 in 2020.

The maximum elective contributions on which the safe harbor match is to be calculated is $19,500 for the NHCE but $26,000 for the HCE. Nonetheless, this is not discriminatory and does not cause the plan to fail to satisfy the safe harbor requirements of IRC §401(k)(12). In addition, if a catch-up eligible participant defers more than $19,500 for 2020, but all or a portion of the amount above $19,500 is less than 6 percent of compensation, the plan's matching formula must apply to the entire amount or the safe harbor under IRC §401(k)(12) is not satisfied.

Safe Harbor Nonelective Contribution

A **safe harbor nonelective contribution** will satisfy the ADP safe harbor contribution requirement if it equals at least 3 percent of the employee's compensation.[11] Note that the formula requirement is the same under the 401(k)(12) safe harbor and the QACA safe harbor.

As with the match, the nonelective contribution must be provided only to the eligible NHCEs. However, the plan may provide that the HCEs also receive the nonelective contribution allocation.

A contribution greater than 3 percent is also permitted.

An eligible NHCE must receive the allocation of the nonelective contribution regardless of whether he or she chooses to make elective contributions under the 401(k) arrangement, and in the case of the QACA safe harbor, regardless of whether the employee is enrolled under the automatic contribution feature, enrolls by affirmative election or affirmatively elects not to enroll to avoid automatic enrollment. Some employers prefer the nonelective contribution because it guarantees at least some retirement savings, even for those participants who do not choose to, or cannot afford to, make elective contributions to the 401(k) plan.

When the employer provides the safe harbor nonelective contribution, its contribution costs are more predictable than they are under the safe harbor matching contribution formula. With the nonelective contribution, all eligible participants (or at least all eligible NHCE participants) will receive the contribution allocation, so the employer will have to budget a fixed contribution cost of 3 percent of compensation for those participants. With the matching contribution, only those

[11] IRC §401(k)(12)(C).

eligible participants who actually defer under the 401(k) arrangement will receive the allocation. The employer's contribution cost under the safe harbor matching contribution, if the basic formula is adopted, could be as high as 4 percent of compensation for the eligible participants, but could be much less than the cost of the nonelective contribution if a significant portion of the eligible participants do not make elective contributions.

If the employer wants to combine a safe harbor 401(k) plan with a cross-tested profit-sharing plan, the 3 percent safe harbor nonelective contribution may be included in the cross-testing. In this way, this contribution does double duty—that is, it takes the place of the ADP test and permits the HCEs to make elective contributions in any amount permitted by the plan document, and it also counts as an employer contribution for the nondiscrimination testing of the profit-sharing contribution.

Other Safe Harbor Contribution Rules

Unless otherwise noted, the rules below apply to the "normal" safe harbor and the QACA safe harbor.

Only One Safe Harbor Contribution Requirement Need Be Satisfied to Eliminate the Need for ADP Testing

Only one of the safe harbor contribution formulas must be provided by the plan to eliminate the ADP test. If the other type of contribution is also provided by the plan, the formula for that contribution would not have to satisfy the safe harbor contribution requirements.[12] For example, suppose an employer wants to provide a matching contribution that equals only 25 percent of the first 4 percent of compensation deferred. If the plan satisfies the safe harbor nonelective contribution requirement, the ADP test would still be eliminated, even though the matching contribution formula does not satisfy the safe harbor matching contribution requirement.

Three-month Rule for New Plans

As a general rule, a new plan may not be a safe harbor plan for the first plan year unless the first plan year is at least three months long and the 401(k) arrangement is in effect for at least three months for that first year.[13]

Using Another Plan for the Safe Harbor Contribution

The safe harbor nonelective contribution or the safe harbor matching contribution formulas do not have to be provided in the same plan that includes the 401(k) arrangement. The employer may, instead, provide the safe harbor contribution in a separate defined contribution plan.[14] If this option is used, it will typically involve the safe harbor nonelective contribution. An employer usually contributes matching contributions to the same plan that includes the contributions being matched. For example, if the employer also maintains a profit-sharing plan that is separate from the 401(k) plan, or also

[12] Treas. Reg. §1.401(k)-3(a).
[13] Treas. Reg. §1.401(k)-3(e)(2).
[14] IRC §401(k)(12)(F), Treas. Reg. §1.401(k)-3(h)(4).

maintains a money purchase plan, the 3 percent nonelective contribution could be satisfied in that other plan.

If You're Curious …

If the contribution is made to a separate plan, the other plan must have the same plan year as the plan that contains the 401(k) arrangement.[15]

The plan that contains the 401(k) arrangement must name the other plan that provides the safe harbor contribution.[16]16 In addition, the plan that provides the safe harbor contribution must provide for the vesting and withdrawal requirements required by IRC §401(k) for elective contributions.[17]

The plan that provides the ADP safe harbor contribution does not have to be otherwise eligible for aggregation with the plan with the 401(k) arrangement.[18] For example, a 3 percent nonelective contribution to an ESOP can satisfy the safe harbor contribution requirement, even though, for pre-2006 plan years, ESOPs and non-ESOPs may not be permissively aggregated.

A pre-approved plan may allow for the safe harbor contribution to be made in another defined contribution plan.[19] If this option is available in the plan, the adoption agreement must have a place for the employer to specify that other plan. If the plan is a standardized pre-approved plan, this option is available only if the other defined contribution plan is a paired plan—that is, two or more plans sponsored by the same pre-approved provider with provisions coordinated with to satisfy IRC §§401(a)(4) and 410(b), separately or on a combined basis.

Safe Harbor Contribution Must Be Required by Plan

The ADP safe harbor contribution, whether a match or a nonelective contribution, must be required by the plan.[20] A discretionary formula will not satisfy the minimum contribution requirement, even if the employer makes a matching contribution or nonelective contribution that is equal to or greater than the prescribed formula. In other words, a trade-off for eliminating the ADP test is to guarantee the NHCEs a certain level of employer contributions. However, as will be discussed below, a **wait-and-see approach** may be employed with respect to the safe harbor nonelective contribution that will provide the employer some flexibility regarding its obligation to make this contribution. In addition, safe harbor contributions may be discontinued or reduced during the year,

[15] Treas. Reg. §1.401(k)-3(h)(4).
[16] Treas. Reg. §1.401(k)-3(e)(1).
[17] Treas. Reg. §1.401(k)-3(h)(4).
[18] Treas. Reg. §1.401(k)-3(h)(4).
[19] Listing of Material Modifications, Cash or Deferred Arrangement (2/21/2000), §3.1.
[20] Treas. Reg. §1.401(k)-3(b)(1) and (c)(1).

but the plan loses its safe harbor status for that year. Therefore, the plan would be required to satisfy the ADP and/or ACP testing for the entire plan year using the current year testing method.

So long as the ADP safe harbor contribution requirement is satisfied, the plan may provide for additional amounts that may be contributed at the employer's discretion. For example, suppose the plan provides for a nonelective contribution of 3 percent of compensation, plus such additional amount that the employer decides to contribute in its discretion. The nonelective contributions would satisfy the ADP safe harbor contribution requirement (assuming the vesting and withdrawals conditions are satisfied) because a minimum nonelective contribution of 3 percent of compensation is required under the terms of the plan. Similarly, the plan could provide for a safe harbor matching contribution using the basic formula, and then provide for additional matching contributions that could be made at the employer's discretion.

If the employer makes both matching contributions and nonelective contributions, one of those types of contributions may be totally discretionary under a safe harbor 401(k) plan, so long as the other contribution is satisfying the ADP safe harbor contribution requirement. For example, if the basic matching contribution is provided, then the nonelective contribution under the plan may be completely discretionary. Alternatively, if the safe harbor nonelective contribution is provided, then the matching contribution under the plan may be completely discretionary.

Note that there are limits on the discretionary matching contribution that is available under a plan that is intended to satisfy the ACP safe harbor. This will be discussed later in this chapter.

Wait-and-see Approach to Safe Harbor Nonelective Contribution

If the employer is intending to provide the 3 percent nonelective contribution as the safe harbor contribution, the plan can actually be designed as an ADP-tested plan, with the ability to amend the plan into a safe harbor plan as late as 30 days before the last day of the plan year.[21]

To use this technique (the **wait-and-see approach**, also termed by many practitioners as the "maybe notice" approach), the plan document must be drafted to provide for normal ADP testing. The employer has to provide a timely safe harbor notice to employees, which generally must be furnished at least 30, but not more than 90, days before the beginning of the plan year. This safe harbor notice would simply indicate that the employer might amend the plan to satisfy the ADP test for that year through the safe harbor nonelective contribution under the ADP safe harbor, and that the employees will be notified in the event of such an amendment. (This type of notice is often referred to by practitioners as a maybe notice, because it tells the participants that maybe the employer will adopt a safe harbor plan.)

If the employer later decides to make the safe harbor nonelective contribution, a supplemental notice must be given no later than 30 days before the end of the plan year. The supplemental notice may be a separate notice or, if applicable, it may include the next plan year's safe harbor notice or maybe notice. The amendment to adopt the ADP safe harbor nonelective contribution has to be signed no later than 30 days before the last day of the plan year. It may provide that the plan is a safe harbor plan only for that year, reverting to an ADP-tested plan for the subsequent year.

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[21] Treas. Reg. §1.401(k)-3(f).

Treasury regulations indicate that there is no limit on the number of years during which this wait-and-see approach may be used.[22]

A plan may not use this wait-and-see approach to the safe harbor nonelective contribution unless, in the event the safe harbor nonelective contribution is not adopted, the plan provides for ADP testing (and, if applicable, ACP testing) using the current year testing method. If the plan provides for the prior year testing method, and the employer would like the flexibility to use the wait-and-see approach to the safe harbor rule, the employer first must amend the plan to adopt the current year testing method.

EXAMPLE 5-11. Wait-and-see Approach. A 401(k) plan has a plan year ending December 31. The plan provides that the ADP test is performed with respect to elective deferrals. However, on December 1, 2019, the employer gives employees the safe harbor notice that states that, for the next plan year (2020), the employer might amend the plan, no later than December 1, 2020, to provide a safe harbor nonelective contribution for 2020 in an amount not less than 3 percent of compensation. In all other respects, the safe harbor notice contains the information that would be provided to eligible employees under a safe harbor 401(k) plan. The notice also provides that, in the event the plan is so amended, the employees will receive a supplemental notice. If the plan is not amended, the plan will default to its normal ADP testing provisions.

By December 1, 2020, the employer amends the plan to provide for the safe harbor nonelective contribution for the 2020 plan year, and provides the eligible employees with a supplemental notice to that effect. The plan will be a safe harbor 401(k) plan for the 2020 plan year and will not have to perform the ADP test. The supplemental notice could also include the safe harbor notice for the next plan year (i.e., the 2021 plan year), the deadline for which is also December 1, 2020.

The key ingredient to the wait-and-see approach is that the employer can assess the status of the ADP test during the plan year and then make a decision regarding whether to adopt the safe harbor nonelective contribution.

Compensation Taken into Account under Safe Harbor Contribution Formula

The statute does not define compensation for purposes of applying the ADP safe harbor contribution formulas discussed above. However, the IRS has clarified that the definition of compensation must satisfy the requirements of IRC §414(s).[23] Generally, an employer will want to design the plan so that the definition of compensation is a safe harbor definition under Treas. Reg. §1.414(s)-1 [i.e., one of the IRC §415 compensation definitions, or a modified definition that satisfies the requirements of Treas. Reg. §1.414(s)-1(c)]. Otherwise, the compensation definition will have to satisfy the nondiscrimination test under Treas. Reg. §1.414(s)-1(d)(3) (sometimes

[22] Treas. Reg. §1.401(k)-3(f)(1).
[23] Treas. Reg. §1.401(k)-3(b)(2).

referred to as the compensation ratio test) for the matching contribution formula or the nonelective contribution formula to satisfy the safe harbor contribution requirement. As the purpose of having a safe harbor plan is usually to avoid nondiscrimination testing, having a compensation formula that requires its own testing is likely counter to the intent of the plan design.

If an employee becomes eligible as of a date other than the first day of the plan year, the plan is able to limit compensation to the period of eligibility to calculate the amount of matching contributions or nonelective contributions required under the prescribed formula.[24] This rule is not mandatory. The plan may, instead, determine compensation for the entire plan year even though the employee is eligible only for part of that year. The provisions of the plan document as to the definition of compensation must be followed.

EXAMPLE 5-12. Effect of Counting Compensation from Date of Entry on Safe Harbor Contribution. Susan becomes a participant in her employer's 401(k) plan on July 1. The plan year ends December 31 and the plan is designed to be a safe harbor 401(k) plan. The plan provides for the safe harbor matching contribution, using the basic formula. Susan's compensation from July 1 to December 31 is $18,000. The plan may provide that Susan's matching contribution is based on $18,000 of compensation, rather than on her compensation for the entire plan year. This would mean a maximum safe harbor matching contribution equal to 100 percent on the first $540 deferred (i.e., 3% x $18,000), plus a match of 50 percent on the next $360 deferred (i.e., 2% x $18,000). So, if Susan defers $900, her match would equal $720 ($540 + $180).

Compare this to the match Susan would receive if her entire year's compensation were taken into account. Suppose that Susan deferred $900, but the plan counted her entire year's compensation under the matching formula, and her compensation for the entire plan year is $36,000. Now $900 would be less than 3 percent of her compensation (i.e., 3% x $36,000 is $1,080), so Susan's match would be $900 under the basic formula.

EXAMPLE 5-13. Effect of Counting Compensation Only from Date of Entry on Safe Harbor Nonelective Contribution. Suppose the plan satisfies the safe harbor on the basis of the nonelective contribution requirement. If the plan limits compensation to the period of eligibility, Susan's non-elective contribution would equal $540 (i.e., 3% x $18,000), rather than 3 percent of her entire year's compensation (i.e., $1,080, if her compensation for the full year was $36,000).

EXAMPLE 5-14. Short First Plan Year. A new 401(k) plan is effective July 1. The plan year ends December 31, so the first plan year is a six-month period that

[24] Treas. Reg. §1.401(k)-3(b)(2).

begins on the July 1 effective date and ends on December 31. The plan is designed as a safe harbor 401(k) plan. Because participants are eligible to defer under the 401(k) arrangement for only six months in the first plan year, the ADP safe harbor contribution may be calculated by taking into account compensation for only that six-month period.

Safe Harbor Matching Contribution may be Determined on a Plan Year Basis or on a Payroll Period Basis

Whether the plan is designed to take into account compensation for the entire plan year or only for the period the employee is eligible, to compute a participant's matching contribution, the employer also must decide whether a matching contribution formula is applied on a plan year basis or on a payroll period basis. Either method is permissible in a safe harbor plan.[25]

The primary difference between the plan year method and the payroll period method is that, under the payroll period method, a "true-up" of matching contributions is not required (or is required only under limited circumstances) when a participant's deferral rate is not uniform during all payroll periods falling in the plan year.

Plan year method. Under the plan year method, the matching contribution formula must take into account compensation for the entire compensation period (i.e., the entire plan year or the entire portion of the plan year during which the employee is eligible to defer) to determine the percentage of compensation deferred by the participant under the 401(k) arrangement. This rule will generally benefit a participant who changes deferral rates during the year.

EXAMPLE 5-15. Plan Year Method. Elaine is eligible for a safe harbor 401(k) plan that satisfies the ADP safe harbor contribution requirement using the basic matching contribution formula. For the current plan year, Elaine's compensation is $30,000 and she is eligible to defer for the entire plan year.

For the first six months of the plan year, Elaine defers at a rate of 6 percent. During that period, Elaine's compensation is $15,000, and her elective contribution amount is $900. For the last six months of the plan year, Elaine discontinues elective contributions.

Under the plan year method, because Elaine was eligible to defer for the entire plan year, her compensation for that entire year is taken into account to determine her deferral rate under the safe harbor matching contribution formula, even though she actually deferred for only six months of the plan year. Elaine's elective contributions for the plan year ($900) represent 3 percent of her entire year's compensation (i.e., $900/$30,000), even though her deferral rate was actually 6 percent during the portion of the plan year in which she deferred. Elaine's match is

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[25] Treas. Reg. §1.401(k)-3(c)(5)(ii).

$900, because the basic matching contribution formula matches 100 percent of the first 3 percent of compensation deferred.

Some 401(k) plans allocate matching contributions throughout the plan year, even though the amount of matching contributions is determined under the plan year method. If the plan is using the plan year method to calculate the safe harbor matching contribution, but matching contribution deposits during the plan year are calculated on a payroll period basis, a "true-up" will be required. In other words, an end-of-year adjustment may need to be made so that the amount of matching contributions actually made for the year is correct based on total compensation and total elective contributions for the year.

EXAMPLE 5-16. "True-up." Suppose the employer in **EXAMPLE 5-15** deposits Elaine's match on a payroll-by-payroll period basis, even though the plan calculates the matching contribution on a plan year basis. Assume there are 12 payroll periods during the first six months of the plan year, and Elaine's compensation for each payroll period is $1,250. Her deferral rate for each of those payroll periods is 6 percent.

Under the basic match formula, only the first 3 percent is matched at a 100 percent rate and then the next 2 percent is matched at a 50 percent rate. If the employer calculates its matching deposits separately for each payroll period, it would deposit $50 for Elaine's account for each payroll period. This is determined as follows. Elaine's elective contribution amount for each payroll period is 6% x $1,250, or $75. The first 3 percent of compensation ($37.50) is matched 100 percent under the formula (match of $37.50), and the next 2 percent of compensation ($25) is matched 50 percent under the formula (match of $12.50). The balance of the elective contribution ($12.50) receives no match. The total matching contribution made is $50 ($37.50 plus $12.50).

At the end of the six-month period, the employer would have made 12 deposits of $50 each for a cumulative match of $600. For the last six months of the year, Elaine is not deferring, so the employer would not make any further matching deposits on Elaine's behalf.

However, because the plan uses the plan year method to calculate the matching contribution, Elaine's actual matching contribution for the plan year should be $900, as discussed in the above example. This would mean that the employer deposited $300 too little during the year and must contribute another $300 to Elaine's account (i.e., "true-up" Elaine's contribution) to bring her total match for the plan year to $900.

Payroll period method. Under the payroll period method, the match is separately determined for each payroll period, on a monthly basis (i.e., all payroll periods ending in each month), or on a quarterly basis (i.e., all payroll periods ending in each plan year quarter). If the monthly basis or quarterly basis is used, and an employee is not eligible for the 401(k) arrangement for a portion of the month or quarter, the safe harbor matching contribution may be determined by taking into

account only the compensation for the portion of the month or quarter during which the employee is eligible for the 401(k) arrangement.

EXAMPLE 5-17. Basic Formula. Assume the facts in **EXAMPLE 5-16**. If the payroll period method is used, Elaine's matching contribution would be the $600 actually contributed during the year, rather than $900. The employer would not have to make a “true-up” contribution.

EXAMPLE 5-18. Enhanced Formula. An employer's safe harbor 401(k) plan has a plan year ending December 31. The plan is using an enhanced formula, which provides a match equal to 100 percent of the first 4 percent of compensation deferred. The payroll period method is used to calculate the matching contribution, determining the match for each payroll period independently.

Mara elects to defer 8 percent of compensation from January 1 through June 30. Her total compensation during that period is $30,000, and her elective contributions total $2,400. During this time the employer contributes a match equal to $1,200, which is 4 percent of $30,000.

Effective July 1, Mara reduces her election to zero percent of compensation. Mara's compensation from July 1 through December 31 is also $30,000. Because the payroll period method is used, there is no further matching contribution liability to Mara under the safe harbor formula.

Had the plan year method been used, Mara would receive another $1,200 of match for the plan year (i.e., the “true-up” contribution) because her total elective contributions for the plan year ($2,400) would equal 4 percent of her entire year's compensation ($60,000), entitling her to 100 percent match on all the elective contributions.

Deposit Requirement for Matching Contributions Under the Payroll Period Method

Normally, matching contributions made to a safe harbor 401(k) plan must be deposited no later than 12 months after the close of the plan year (although an employer usually will deposit the match relating to a tax year by the due date of its tax return for the tax year, so that the contributions are deductible for that tax year). However, if the plan uses the payroll period method, the match for elective contributions and after-tax employee contributions made during a plan year quarter must be deposited no later than the last day of the next quarter.[26] For example, suppose the employer determines the safe harbor match separately for each payroll period and the plan year is the calendar year. For elective contributions and after-tax employee contributions made during the third quarter of

[26] Treas. Reg. §1.401(k)-3(c)(5)(ii).

the plan year (July 1 – September 30), the matching contributions would have to be deposited by December 31.

No Allocation Conditions May Be Imposed on Safe Harbor Contribution

The statute does not provide any exceptions to an eligible employee's right to accrue the safe harbor contribution. In other words, a plan may not require that the eligible employee complete a minimum number of hours of service for the plan year (e.g., 1,000 hours) or be employed on the last day of the plan year to be entitled to the safe harbor matching contribution or the safe harbor nonelective contribution. The IRS guidance provides that the safe harbor contribution must be allocated to all NHCEs who are eligible employees under the 401(k) arrangement.[27]

Even if the plan could pass coverage under IRC §410(b) with respect to the safe harbor contributions if employees who terminate during the plan year or fail to earn a minimum number of hours for that year did not receive an allocation of the safe harbor contribution, the safe harbor contribution nonetheless must be made on behalf of all eligible NHCEs.[28] Final regulations clarified that a QACA does not have to match an employee contribution that was withdrawn by a participant exercising the 90-day withdrawal option, prior to when the match would have been allocated.

EXAMPLE 5-19. No Allocation Conditions. A 401(k) plan is designed to be a safe harbor plan by providing the basic matching contribution formula. The plan year ends December 31. For the current plan year, Mumford, an eligible NHCE employee, quits on November 1. Mumford's elective contributions for the plan year totaled 2 percent of his compensation.

The employer is required to make a matching contribution for Mumford that equals 2 percent of his compensation (i.e., 100 percent match on the first 3 percent deferred), even though Mumford quit during the year. If the plan provided the safe harbor nonelective contribution instead, the nonelective contribution for Mumford would equal 3 percent of his compensation, regardless of the fact that he is not employed on the last day of the plan year.

Although an eligible employee may not be required to satisfy additional accrual requirements, such as last-day employment or 1,000 hours in the plan year, to receive an allocation of the safe harbor contribution, the safe harbor 401(k) plan may impose the normal eligibility conditions to become eligible for the plan. For example, a safe harbor 401(k) plan may require an employee to complete a year of service (which may require up to 1,000 hours of service to be completed in an eligibility computation period) and attain age 21 before becoming eligible to participate in the 401(k) arrangement. However, once the employee completes those requirements and becomes eligible to

[27] Treas. Reg. §1.401(k)-3(b).
[28] Treas. Reg. §1.401(k)-3(c)(7), Example 4.

participate in the 401(k) arrangement, annual requirements may not be imposed on the employee's right to receive the safe harbor contribution.

It is not permissible to require employees to complete two years of service to be eligible to receive allocations of safe harbor contributions.[29] The plan may impose a two-year eligibility requirement on other employer contributions, but not on the safe harbor contribution.

If a safe harbor 401(k) plan imposes an eligibility condition that is less than the statutory maximum (i.e., less than one year of service and/or less than age 21), the safe harbor provisions may be applied solely to the employees who have satisfied the maximum statutory eligibility requirements. It should be noted, however, that applying the safe harbor feature solely to employees who have satisfied the statutory eligibility requirements has the potential to impact other areas of compliance, the details of which are outside the scope of this textbook.

Employer Deposit Requirements

The safe harbor contributions must be deposited to the plan no later than 12 months after the close of the plan year.[30] This is consistent with the timing rules for QMACs and QNECs that are used in ADP-tested 401(k) plans. However, if the employer wants to deduct the contribution for a particular taxable year, the contribution must be made by the due date (including extensions) for filing the employer's federal income tax return for that year.[31] Because of the deduction issue, safe harbor contributions relating to a plan year usually will be made well before the end of the 12-month period following the close of that plan year.

The employer may contribute these amounts during the year, so long as the aggregate contributions allocated to a participant for the entire plan year equal the appropriate amount under the safe harbor contribution formula. For example, an employer may want to deposit the safe harbor contributions on a monthly basis.

Remember that there is a rule discussed above that imposes an earlier deposit deadline for the safe harbor matching contribution if that contribution is calculated under the payroll period method.

VESTING REQUIREMENT

For a plan that is relying on the 401(k)(12) safe harbor, the ADP safe harbor contribution must be 100 percent vested, regardless of the employee's length of service.[32] This requirement is not satisfied if the plan contains a vesting schedule for such contributions but all eligible employees happen to have enough service to be at 100 percent under that schedule. Because only one safe harbor contribution must be provided, 100 percent vesting is required only for the contribution that is being used to satisfy the ADP safe harbor contribution requirement. For example, the employer could provide a vesting schedule on the matching contributions and 100 percent vesting on the nonelective

[29] IRC §401(k)(2)(D).
[30] Treas. Reg. §1.401(k)-3(h)(1).
[31] IRC §404(a)(6).
[32] IRC §401(k)(12)(E)(i).

contributions and satisfy the ADP safe harbor requirement, so long as the nonelective contributions satisfy the safe harbor contribution requirement.

ADP safe harbor contributions made under the QACA safe harbor must be 100 percent vested for any employee who has completed at least two years of service for vesting purposes. The plan may provide for zero percent vesting for an employee who has not completed at least two years of service, or may provide for any greater percentage. An employer might find this more attractive than the immediate vesting applicable to a 401(k)(12) safe harbor. On the other hand, an employer may not want to meet the automatic enrollment requirements under the QACA safe harbor.

Non-Safe Harbor Contributions May Be Subject to Vesting Schedule

If the contribution formula provides more than is required for the safe harbor, the additional amount could be subject to a vesting schedule. Consider, for example, a matching contribution formula that equals 100 percent of the first 3 percent deferred, plus 50 percent of the next 2 percent deferred, and also authorizes the employer to make additional matching contributions on a discretionary basis. The fixed matching contribution is 100 percent vested, but the discretionary match is subject to a vesting schedule. The application of the vesting schedule to the discretionary match does not cause the plan to fail the ADP safe harbor, because the fixed match satisfies the safe harbor matching contribution requirement and it is 100 percent vested.

If You're Curious …

Converted Plan Does Not Have to Vest Prior Contributions

If an existing plan is converted into a safe harbor 401(k) plan, contributions of the same type as the safe harbor contribution (i.e., matching or nonelective) that were accrued before the plan became a safe harbor plan would not have to be subject to the 100 percent vesting requirement. The employer should consider the additional recordkeeping issues involved with maintaining the original vesting schedule on previously accrued non-safe harbor contributions.

EXAMPLE 5-20. Converted Plan. A 401(k) plan is converted to a safe harbor 401(k) plan, effective for its plan year beginning January 1, 2020. To satisfy the ADP safe harbor contribution requirement, the plan provides for a safe harbor matching contribution using the basic formula. For pre-2020 plan years, the plan had provided matching contributions that were subject to a six-year vesting schedule. The matching contributions made for such plan years could continue to be subject to that vesting schedule after the effective date of the safe harbor provisions.

If a 401(k)(12) safe harbor plan is converted into a QACA safe harbor plan, existing participants who already have earned a 100 percent right to safe harbor contributions could not become subject to the two-year vesting rule, even with respect to future safe harbor contributions under the QACA rules.

> If the plan is going to preserve the vesting schedule for contributions relating to non-safe harbor years or to contributions made in addition to the safe harbor contributions, the employer must ensure that proper recordkeeping procedures are in place. A participant's account might include some contributions that are subject to the vesting schedule and other contributions that are 100 percent vested. These differences in vesting will apply not only to the underlying contributions, but also to the earnings on those contributions. Therefore, the net earnings on investments will have to be separately accounted for with respect to each source of contribution. In addition, the chances for human error are increased with respect to the calculation of a participant's vested account balance.

WITHDRAWAL RESTRICTIONS

Participant withdrawals of the ADP safe harbor contributions must be restricted in accordance with the distribution restrictions that apply to elective contributions under IRC §401(k)(2)—i.e., no distributions before severance of employment, retirement, attainment of age 59½, disability, certain payments to qualified reservists or certain plan terminations.[33]

Although IRC §401(k)(2) includes the right to withdraw contributions for hardship, that right applied only to the elective contributions, and not to other employer contributions that are restricted by statute to the IRC §401(k) withdrawal restrictions prior to the 2019 plan year. Effective with the 2019 plan year, a plan may allow safe harbor contributions to be part of a hardship withdrawal.

Prior to 2020, if a safe harbor 401(k) plan allowed participants to take hardship withdrawals of their elective contributions, and the plan has a matching contribution, any suspension period on the right to make elective contributions must not have been greater than six months.[34] However, effective January 1, 2020 plans are not allowed to suspend elective deferrals due to a hardship withdrawal.

If the plan provides contributions other than the ADP safe harbor contribution (e.g., a discretionary nonelective contribution), such contributions may be distributed on account of the participant's hardship or in relation to any other distribution event that is permitted under a non-pension plan, even if such event does not satisfy the restrictions under IRC §401(k)(2). For example, suppose the plan satisfies the safe harbor nonelective contribution but also provides for a matching contribution. Because the ADP safe harbor is satisfied through the nonelective contributions, only those contributions were subject to the deferral-like withdrawal restrictions prior to the 2019 plan

[33] IRC §401(k)(12)(E)(i).
[34] Treas. Reg. §1.401(k)-3(c)(6)(v)(B).

year. The non-safe harbor matching contributions could be eligible for any in-service withdrawal provisions stated in the plan (including hardship).

ANNUAL NOTICE REQUIREMENT

A safe harbor 401(k) plan must provide the eligible employees with an annual written notice that describes the employees' rights and obligations under the arrangement.[35] The annual notice requirement was a necessary element to obtaining the Treasury's support for the legislation that created the safe harbor option. With the elimination of the ADP test, the Treasury was concerned that an employer would have less incentive to encourage enrollment by the NHCEs. In fact, when a safe harbor matching contribution formula is provided, an employer might prefer lesser enrollment, thus reducing its matching contribution costs. The annual notice requirement serves as a reminder to the employees of the advantages of participating in the 401(k) arrangement and how they make (or modify) deferral elections.

Requirements for Notice

The notice must be sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations under the plan. It must be written in a manner that is calculated to be understood by the average employee eligible to participate.[36]

Contents of 401(k)(12) Safe Harbor Notice

The 401(k)(12) safe harbor notice must contain the following:

1. the safe harbor matching or nonelective contribution formula used in the plan;
4. any other contributions under the plan (including the potential for a discretionary matching or nonelective contribution) and the conditions under which such contributions are made;
5. the plan to which the safe harbor contributions are made, if different from the plan that includes the 401(k) arrangement;
6. the type and amount of compensation that can be deferred;
7. how to make deferral elections, including any administrative requirements that apply to such elections;
8. the periods available under the plan for making a cash or deferred election;
9. the withdrawal and vesting provisions applicable to contributions under the plan; and
10. information that makes it easy to obtain additional information about the plan (including an additional copy of the SPD), such as telephone numbers, addresses and, if applicable, electronic addresses of individuals or offices from whom employees can obtain such plan information.[37]

The employer may supply much of the information required in the safe harbor notice in the SPD and cross-reference to the appropriate SPD sections in the safe harbor notice. This cross-reference

[35] IRC §401(k)(12)(D).
[36] IRC §401(k)(12)(D), Treas. Reg. §1.401(k)-3(d).
[37] Treas. Reg. §1.401(k)-3(d)(2)(i).

option is available for information described in items (2), (3), and (4). The other items identified above may not be cross-referenced in the SPD.[38]

Contents of QACA Safe Harbor Notice

The QACA safe harbor notice must contain the following information, in addition to the information reflected above for the regular safe harbor notice:

1. the level of elective contributions that will be made on the employee's behalf if he or she does not make an affirmative election;
2. an explanation of the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made at a different percentage);
3. an explanation of how contributions made under the arrangement will be invested in the absence of any investment election by the employee;[39] and
4. a statement as to whether the automatic elective contributions will be pre-tax or Roth after-tax amounts.

Electronic Delivery of Notice Permitted

The IRS set uniform standards for using electronic media for all notices required by the IRC. Under these standards, certain notices may be provided in electronic form. The rules vary, depending on whether the electronic means is something to which a given participant has readily available access (such as an emailed notice to an employee who has a computer and company email address as a part of his or her job at the company) or whether a participant without such access has affirmatively consented to electronic delivery (e.g., at his or her home email address). On a practical basis, it is likely that electronic noticing is an available alternative only for companies with mostly computer-networked employees.[40]

Timing of Notice

Normally, the notice must be given within a reasonable time before the first day of the plan year.[41] The IRS deems this timing requirement to be satisfied if the notice is given between 30 and 90 days before the beginning of the plan year.[42]

EXAMPLE 5-21. Illustration of General Notice Period. A 401(k) plan has a plan year ending December 31. For the plan year beginning January 1, 2020, the employer wants to convert the plan to a safe harbor plan. To satisfy the IRS' timing rule, the notice must be given no earlier October 2, 2019, and no later than December 1, 2019. If notice is not given by December 1, 2019, the plan may not be converted into a safe harbor plan earlier than the 2021 plan year.

[38] Treas. Reg. §1.401(k)-3(d)(2)(iii).
[39] Treas. Reg. §1.401(k)-3(k)(4).
[40] See, Treas. Reg. §1.401(a)-21.
[41] IRC §401(k)(12)(D).
[42] Treas. Reg. §1.401(k)-3(d)(3)(ii).

The timing requirement is deemed satisfied with regard to an employee who becomes eligible later than the 90th day before the beginning of the plan year if the notice is given by his or her date of eligibility (but not earlier than 90 days before his or her eligibility date).[43]

New Safe Harbor Plan

This rule also applies to the first plan year of a new 401(k) plan, with respect to employees who are eligible to participate in the plan for that first plan year. Thus, notice may be given up to the first day of the first plan year of a new safe harbor 401(k) plan. In other words, the IRS treats employees who are eligible under a new 401(k) plan to be in the same position as an employee who first qualifies for participation in an existing 401(k) plan.[44]

EXAMPLE 5-22. New Safe Harbor Plan. An employer establishes a new 401(k) plan. The 401(k) arrangement is effective August 1. The plan year ends December 31, so the notice is timely for the employees who are eligible as of the August 1 effective date, if the notice is given no later than such effective date (but no earlier than 90 days before August 1).

Note that the plan itself may also be effective as of August 1, so that the first plan year is a short plan year, or it may be effective as of an earlier date (e.g., retroactive to the preceding January 1). The 401(k) arrangement itself, however, cannot be effective earlier than the date the plan is adopted.[45] The timing of the first safe harbor notice is based on the first date (August 1 in this example) on which employees are first eligible to defer compensation under the new 401(k) arrangement.

If You're Curious…

Conversion of Existing Plan into a Safe Harbor 401(k) Plan

If a 401(k) plan is converted into a safe harbor 401(k) plan, the special rule discussed above would not apply. The general notice period would apply. Thus, notice would have to be given 30 to 90 days before the first day of the plan year for which the conversion is first effective. Furthermore, the effective date of the conversion could not be before the start of the next plan year.

EXAMPLE 5-23. Late Notices. The plan year of a 401(k) plan begins on January 1. After the 2019 plan year has started, the employer decides that it would like to convert

[43] Treas. Reg. §1.401(k)-3(d)(3)(ii).
[44] Treas. Reg. §1.401(k)-3(d)(3)(ii).
[45] Treas. Reg. §1.401(k)-1(a)(3)(ii).

the plan to a safe harbor 401(k) plan for the current plan year, but not effective until May 1, 2019.

It is too late to provide notice for the current plan year because employees who were eligible to defer as of the first day of the plan year will not get timely notice. Notice for a plan year beginning January 1, 2020, must be given 30 to 90 days before that January 1, if employees are eligible to defer under the 401(k) arrangement on such date. The earliest the plan can qualify for the ADP safe harbor is the next plan year (the 2020 plan year).

The employer cannot do an end-run around this rule by simply adopting a separate new 401(k) plan, but have a short plan year so that a calendar plan year can be maintained (e.g., a new plan is adopted with an effective date of May 1, 2019, with the first plan year ending December 31, 2019). A successor plan may not have a short plan year if it wants to use the safe harbor rules.[46]

Conversion of Non-401(k) Plan to Safe Harbor 401(k) Plan

If the plan is not a 401(k) plan at the time of the conversion, then the conversion is creating a new 401(k) arrangement, and a conversion as of a date other than the first day of the plan year is permitted. In other words, the new plan rule described above is applicable.[47] Thus, the employer may add the 401(k) arrangement after the first day of the plan year, and the notice requirements can be satisfied as late as the effective date of the 401(k) arrangement. If notice is given less than 30 days before the effective date of the 401(k) arrangement, participants must have at least 30 days following receipt of the notice to make deferral elections under the plan. As is the case with the establishment of a new plan, a safe harbor 401(k) arrangement may not be added to an existing non-401(k) plan unless the 401(k) arrangement will be in effect for at least three months.

EXAMPLE 5-24. Adding Safe Harbor Provision to Profit-Sharing Plan. Company X maintains a profit-sharing plan. There is no 401(k) arrangement in the plan. The plan year ends December 31. Company X may add a safe harbor 401(k) arrangement for the 2019 plan year as late as October 1, 2019. The safe harbor notice would have to be given no later than the effective date of the 401(k) arrangement, and the safe harbor provisions would have to be satisfied from the effective date of the arrangement through the end of the plan year.

EXAMPLE 5-25. New Plan with Retroactive Effective Date. Company X is adopting a plan for the first time during 2018. The plan year will end December 31. Company X executes a 401(k) adoption agreement under a pre-approved document on May 25, 2019. The plan is made effective retroactive to January 1, 2019, but the 401(k) arrangement is made effective as of June 1, 2019. So long as the safe harbor notice is given by June 1, 2019, and the other safe harbor conditions are satisfied from June 1 through December

[46] Treas. Reg. §1.401(k)-3(e)(2).
[47] Treas. Reg. §1.401(k)-3(e)(2).

31, 2019, the 401(k) arrangement can qualify for the ADP/ACP safe harbors for the first plan year.

The plan may not be a successor plan and use this new plan rule for provision of the safe harbor notice. A plan is a successor plan if at least 50 percent of the eligible employees were eligible for a 401(k) arrangement maintained by the employer in the prior year.

EXAMPLE 5-26. Successor Plan. Company X maintains a 401(k) plan for its employees and the employees of its subsidiary, Company Y. Company Y also maintains a separate profit-sharing plan that covers only Company Y employees. Both plans use the calendar year as the plan year. Effective May 1, 2019, Company Y adopts a 401(k) arrangement under its separate profit-sharing plan and the Company Y employees cease their participation in the 401(k) plan maintained jointly with Company X. The Company Y 401(k) plan is a successor plan to the 401(k) plan in which Company Y previously participated with Company X, so the new plan rule is not available. Thus, Company Y's plan may not be a safe harbor 401(k) plan for the 2019 plan year. However, it is eligible to be treated as a safe harbor 401(k) plan for the next plan year (i.e., the 2020 plan year), if the notice requirements are timely satisfied for that year.

Consequences of Failing to Give Timely Notice

The notice is a condition to relying on the ADP safe harbor. If notice is not given on a timely basis, the employer has failed to operate the plan in accordance with its terms.

While practitioners may hope that the IRS would excuse de minimis failures, such as the failure to give notice to a small percentage of the eligible employees, so long as notice was given to such employees as soon as administratively feasible after the error is discovered, there is no guidance on point.

The IRS has indicated informally that it may permit correction of the untimely notice through the Employee Plans Compliance Resolution System (EPCRS), through the application procedures of the Voluntary Correction Program (VCP), or possibly through the Self-Correction Program (SCP). The failure to give notice would be an operational failure under EPCRS because the terms of the plan have not been followed.

Consequences of Failing to Comply With Other Safe Harbor Requirements

IRS correction procedures are similarly vague if other safe harbor requirements are violated. The IRS has been clear that the ramifications of failing to comply with the safe harbor rules do not mean that the plan is subject to ADP testing. While the EPCRS guidance provides very detailed corrections for when participants are not timely enrolled,[48] there is no correction outlined for a failure to provide timely notice or a failure to fund the safe harbor contribution within 12 months

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[48] Rev, Proc. 2015-28, Rev. Proc. 2013-12, Appendix B, §2.02.

of the plan year end. Without any real guidance on proper corrections, it is likely prudent to file under VCP in order to negotiate and gain approval of a correction with the IRS.

5.05: ACP Safe Harbor

In the prior parts of this chapter, we discuss the requirements for a safe harbor 401(k) plan to satisfy the ADP safe harbor and, thus, exempt itself from the ADP test. A safe harbor 401(k) plan may include matching contributions. Sometimes the matching contributions are designed to satisfy the ADP safe harbor contribution requirement and sometimes the matching contributions are made in addition to the ADP safe harbor contribution. For example, a plan may meet the ADP safe harbor by using the three percent nonelective contribution, and then have a matching contribution that it would like to have meet the ACP safe harbor (that is, to be exempt from ACP testing). Alternatively, the plan may meet the ADP safe harbor by using the safe harbor basic or enhanced matching contributions, but the employer wants to have the option of contributing additional match amounts without having to run the ACP test.

If the matching contribution formula is not used to meet the ADP safe harbor but is offered under a safe harbor 401(k) plan, it may be deemed to satisfy the ACP test if it satisfies certain requirements. We will refer to this as the **ACP safe harbor**.

It is easy to get confused by whether a matching contribution relates to the ADP or ACP test. The best way to resolve this confusion is to first ask: how is the plan satisfying the ADP safe harbor? If there is a matching contribution that is not being used to meet the ADP testing, that matching contribution is subject to ACP testing unless the ACP safe harbor is met.

MATCHING FORMULA REQUIREMENTS

To qualify for the ACP safe harbor, the matching formula must satisfy the conditions outlined in IRC §401(m)(11) (for a matching contribution in a plan that meets the 401(k)(12) safe harbor) or IRC §401(m)(12) (for a matching contribution in a plan that meets the QACA safe harbor).

Limit on Contributions That Can Be Matched

Matching contributions that are intended to meet the ACP safe harbor may not be made with respect to elective contributions in excess of 6 percent of compensation.[49] This does not mean that the amount of matching contributions is limited to 6 percent of compensation. It means that, in determining the amount of a participant's matching contributions, elective contributions that are in excess of 6 percent of compensation must be disregarded.

If the matching contribution formula applies to after-tax employee contributions in addition to, or in lieu of, elective contributions, the 6 percent rule applies to those contributions, as well.

EXAMPLE 5-27. Match Applies to Contributions Above 6 Percent of Compensation. A safe harbor 401(k) plan provides a matching contribution that

[49] IRC §401(m)(11)(B)(i).

equals 25 percent of elective contributions, taking into account only contributions that do not exceed 10 percent of compensation. This matching contribution formula cannot qualify for the ACP safe harbor because matching contributions are made on elective contributions that exceed 6 percent of compensation. Thus, the matching contributions must satisfy the ACP test. Note that the described matching contribution would not satisfy the conditions for the ADP safe harbor either, so the employer must provide the safe harbor nonelective contribution if the plan is to be a safe harbor 401(k) plan.

EXAMPLE 5-28. Amount of Match Exceeds 6 Percent of Compensation. A safe harbor 401(k) plan provides a matching contribution that equals 200 percent of the first 5 percent of compensation deferred. Although the amount of the matching contribution could exceed 6 percent of compensation (e.g., a participant who defers 5 percent of compensation receives a matching contribution equal to 10 percent of compensation), the matching contribution formula satisfies the 6 percent condition for the ACP safe harbor. It is not the matching contribution itself that is limited to 6 percent. The 6 percent limit applies to the elective contributions that are being matched.

If the safe harbor 401(k) plan provides for a match on catch-up contributions, such matching contributions also must satisfy these formula requirements, or the ACP safe harbor is not satisfied. For example, if a participant's catch-up contributions are elective contributions that exceed 6 percent of the participant's compensation, the match will not satisfy the ACP safe harbor if those amounts are matched. IRC §414(v) exempts catch-up contributions from various statutory requirements, but it does not exempt matching contributions that are allocated with respect to catch-up contributions.

Matching Rate Cannot Increase as Rate of Deferrals or Contributions Increases

The matching formula cannot provide a higher rate of match as the participant's rate of elective contributions or after-tax employee contributions increases.[50] This same rule applies to the enhanced matching contribution formula under the ADP safe harbor.

EXAMPLE 5-29. Increasing Matching Rates. A safe harbor 401(k) plan provides for a matching contribution that equals 100 percent of the first 3 percent of compensation deferred plus 150 percent of the next 3 percent of compensation deferred. This formula would not satisfy the ACP safe harbor because the matching contribution is a higher rate as the rate of deferral increases (e.g., the

[50] IRC §401(m)(11)(B)(ii).

rate of match is higher for a participant who defers 4 percent of compensation than for a participant who defers 2 percent of compensation).

Nondiscrimination Requirement

The matching contributions made for any eligible HCE at any rate of elective contributions cannot be greater than that for any eligible NHCE who contributes at the same rate.[51]

EXAMPLE 5-30. Different Matching Rate for Different Employee Groups. Suppose a plan provides for a 50 percent match on the first 5 percent deferred by participants who are salaried employees, but provides only a 25 percent match on the first 5 percent deferred by participants who are hourly paid employees. If there are HCEs in the salaried employee group, the nondiscrimination requirement is not satisfied, because the tiered formula would result in HCEs who receive higher levels of matching contributions than hourly paid NHCEs that defer at the same rate. This is the same rule that applies to the enhanced matching contribution formula under the ADP safe harbor.

Compensation Definition

The compensation definition used in the matching formula (e.g., to determine the amount of elective contributions that is eligible for the match) must satisfy the nondiscrimination requirements of IRC §414(s).[52]

Discretionary Match Limited to 4 Percent of Compensation

A safe harbor matching contribution may be made under a fixed contribution formula or a discretionary contribution formula. Discretionary matching contributions are eligible for the ACP test safe harbor so long as the discretionary matching contributions made on any participant's behalf for the plan year may not exceed 4 percent of compensation.[53]

EXAMPLE 5-31. Discretionary Matching Contributions. A 401(k) plan satisfies the ADP test safe harbor by providing the safe harbor nonelective contribution. The plan also provides for a matching contribution formula. Under the formula, the matching contribution is discretionary, but the matching contribution determined each year by the employer is restricted under the terms of the plan as follows:

1. the matching contribution is allocated only on elective contributions that do not exceed 6 percent of compensation,

[51] IRC §401(m)(11)(B)(iii).
[52] Treas. Reg. §1.401(m)-3(d)(3).
[53] Treas. Reg. §1.401(m)-3(d)(3)(ii).

2. the rate of match is uniform on all elective contributions that are eligible for the match, and
3. the maximum matching contribution that may be allocated to any eligible employee for the plan year may not exceed 4 percent of compensation.

The plan satisfies the ACP test safe harbor. First, the participants who are eligible for the match are eligible for a 401(k) arrangement that satisfies the ADP test safe harbor. Second, the matching contribution, although determined under a discretionary formula, satisfies the limitations discussed above.

Compare this rule with the rule for safe harbor matching contributions under the ADP test safe harbor, where a totally discretionary matching contribution may not be treated as satisfying the safe harbor contribution requirement for the ADP test safe harbor. Thus, if the employer also wants to use the matching contribution to enable the 401(k) arrangement to satisfy the ADP safe harbor, the match would have to be made under a fixed contribution formula that satisfies the requirements under IRC §401(k)(12) for the ADP safe harbor. Alternatively, the employer could satisfy the ADP safe harbor with a safe harbor nonelective contribution, and then have a purely discretionary matching contribution that can be designed to qualify solely for the ACP safe harbor.

No Allocation Conditions Permitted

Although IRC §401(m)(11) does not expressly prohibit the plan from imposing allocation conditions (e.g., at least 1,000 hours of service for the plan year and/or employment on the last day of the plan year) for the matching contribution, the final 401(k) regulations preclude the use of allocation conditions on matching contributions for the ACP safe harbor, as well as for the ADP safe harbor.[54]

If You're Curious …

The plan's matching contribution formula might have two parts. One part of the formula might provide the safe harbor match under IRC §401(k)(12)(B), either under a basic formula or an enhanced formula. The other part of the formula would provide an additional match which, together with the first part of the match, satisfies the formula requirements for the ACP safe harbor. Would it be permissible for the additional match part of the formula to impose allocation conditions and still qualify as an ACP safe harbor match? No, because the law requires that, if an NHCE and an HCE defer at the same rate, they must be entitled to the same rate of match under an ACP safe harbor plan.

Suppose an NHCE and an HCE both defer at a rate of 6 percent of compensation. However, the additional match is made only if a participant is employed on the last day of the plan year and the NHCE terminates employment during the plan year. This would result in the NHCE receiving only the first part of the match [the safe harbor match under IRC §401(k)(12)(B)] and the HCE receiving both parts of the match on the same amount

[54] Treas. Reg. §1.401(m)-3(d)(4).

of elective contributions. This violates the nondiscrimination requirement and the provision in the final 401(k) regulations described above.

EXAMPLE 5-32. ACP Safe Harbor Unavailable if there are Last-day Conditions on the Match. A safe harbor 401(k) plan provides for the 3 percent safe harbor nonelective contribution for all employees who are eligible for the 401(k) arrangement. The plan also provides for a matching contribution equal to 50 percent of the first 4 percent deferred. The matching contribution is available only for eligible employees who are employed by the employer as of the last day of the plan year. The plan satisfies the ADP safe harbor because of the nonelective contribution. However, the matching contributions would not satisfy the ACP safe harbor under the regulations.

Matching contributions that satisfy only the requirements for the ACP safe harbor may be subject to a vesting schedule. Remember that a safe harbor 401(k) plan must have a fully vested safe harbor contribution. The 3 percent nonelective contribution, basic match, or enhanced match that is used for purposes of the ADP safe harbor must be fully vested.[55] However, the ACP match is a matching contribution that is not used for ADP safe harbor purposes. That matching contribution may be subject to a vesting schedule.

Plan Must Satisfy the ADP Safe Harbor to Use ACP Safe Harbor

The matching contributions are not deemed to pass the ACP test, even if the requirements described above are satisfied, unless the 401(k) plan is a safe harbor plan for purposes of the ADP test.[56] In other words, it is not possible to have a 401(k) plan that is deemed to pass the ACP test under the ACP safe harbor with respect to its matching contributions, but does not pass the ADP safe harbor with respect to its elective contributions. It is possible, however, to have a 401(k) plan that passes the ADP safe harbor with respect to its elective contributions but does not pass the ACP safe harbor with respect to its matching contributions.

EXAMPLE 5-33. Plan Fails to Satisfy ADP Safe Harbor. A 401(k) plan provides a matching contribution that equals 50 percent of the first 5 percent of compensation deferred under the 401(k) arrangement. The matching contributions are subject to a six-year vesting schedule. There are no nonelective contributions under the plan. The plan is not a safe harbor 401(k) plan because the matching contribution does not satisfy the contribution requirement to enable the elective contributions to satisfy the ADP safe harbor and there is no nonelective contribution to satisfy that requirement. Without a valid ADP safe harbor contribution, the plan is not eligible for the ACP safe harbor, even if the matching contribution meets the requirements for the safe harbor.

[55] IRC §401(k)(12)(B) and (C).
[56] IRC §401(m)(11)(A)(i).

EXAMPLE 5-34. ADP Safe Harbor met by Nonelective Contribution. Suppose the plan in the prior **EXAMPLE 5-33** also provides for the 3 percent safe harbor nonelective contribution under IRC §401(k)(12)(C). The plan also satisfies all of the other requirements (e.g., notice requirements) for a safe harbor 401(k) plan. Now the plan satisfies the ADP safe harbor with respect to the elective contributions because of the nonelective contribution. The matching contributions are eligible for the ACP safe harbor because the plan is a safe harbor 401(k) plan. Because the matching formula satisfies the requirements described above, the matching contributions are deemed to pass the ACP test.

EXAMPLE 5-35. Matching Formula Fails to Satisfy ACP Safe Harbor. A 401(k) plan provides for a nonelective contribution equal to 3 percent of compensation, and that contribution is 100 percent vested and subject to the 401(k) distribution restrictions. The plan also satisfies all of the other requirements (e.g., notice requirements) for a safe harbor 401(k) plan. Therefore, the elective contributions satisfy the ADP safe harbor because the nonelective contribution satisfies the safe harbor contribution requirement under IRC §401(k)(12)(C). The matching formula is 50 percent of the first 8 percent of compensation deferred under the 401(k) arrangement. The matching contribution is 100 percent vested.

The matching contribution does not satisfy the ACP safe harbor because matching contributions are made on elective contributions that exceed 6 percent of compensation. This is an example of a safe harbor 401(k) plan that satisfies the ADP safe harbor but not the ACP safe harbor. Under this type of plan, no ADP test is performed but an ACP test is required.

The basic matching contribution formula under the ADP safe harbor satisfies the formula requirements described above. Thus, if a safe harbor 401(k) plan provides for the safe harbor matching contribution using the basic formula, and there are no other matching contributions in the plan, the match automatically satisfies the ACP safe harbor. So long as there are no after-tax employee contributions, the plan would have no ADP or ACP testing requirement. In other words, the matching contributions that are used to satisfy the ADP safe harbor contribution requirement are also eligible for the ACP safe harbor.

The enhanced matching contribution formula under the ADP safe harbor may or may not satisfy the ACP safe harbor requirements. That is because, under the ADP safe harbor, the IRC does not require the same 6 percent limitation on matched deferrals required as it does under the ACP safe harbor. However, if the enhanced formula is designed so that the contributions eligible for match

are limited to 6 percent of compensation, and the enhanced match is the only match provided under the safe harbor 401(k) plan, the matching contributions will satisfy the ACP safe harbor.

Does the ACP Safe Harbor Apply for Other Matching Contribution Formulas?

If the matching contribution under the safe harbor 401(k) plan does not satisfy the rules shown above for the basic match and the enhanced match, the matching contributions satisfy the ACP safe harbor only if they satisfy the conditions described above. This includes a plan that provides for matching contributions in addition to the basic or enhanced match, and a plan that provides matching contributions under a formula that does not satisfy either the basic or enhanced match.

Plan Providing an Additional Match

If a plan provides the basic or enhanced matching contributions, but also makes additional matching contributions, the employer will have to determine whether all of the matching contributions combined (including the basic or enhanced match) satisfy the formula requirements for the ACP safe harbor. If they do, then no ACP test is required on the matching contributions. If they do not, then the ACP test will need to be run. When running the ACP test, certain contributions may be disregarded. See the special testing rules described below.

EXAMPLE 5-36. Two Matching Formulas. A safe harbor 401(k) plan provides two matching contribution formulas. One formula provides a match of 100 percent on the first 3 percent deferred plus 50 percent on the next 2 percent deferred. This match is 100 percent vested and subject to the withdrawal restrictions applicable to 401(k) arrangements. The second formula is a discretionary match subject to a vesting schedule, and is a uniform percentage of the first 5 percent deferred (as determined by the employer), but the match is capped at 4 percent of compensation. For the current plan year, the discretionary match is 30 percent of the first 5 percent deferred.

The first formula qualifies the plan for the ADP safe harbor, because it is the basic formula described in IRC §401(k)(12)(B)(i). Therefore, the elective deferrals do not have to be tested under the ADP test for this plan year. To determine if the ACP safe harbor is satisfied, the combined match under both formulas must be examined under the ACP safe harbor requirements. The two formulas combined have provided a participant 130 percent on the first 3 percent deferred and 80 percent on the next 2 percent deferred. This satisfies the formula requirements for the ACP safe harbor. Because the second formula is discretionary, it must be capped at 4 percent of compensation to qualify for the ACP safe harbor, which it does. The plan satisfies the ACP safe harbor with respect to all of its matching contributions.

If the second formula did not cap the discretionary match at 4 percent of compensation, or allowed the discretionary matching contribution rate to apply to elective contributions in excess of 6 percent of compensation, then the second formula would cause the plan to fail the ACP safe harbor with respect to its matching contributions, and the ACP test would have to be run. However, the ADP

safe harbor would still be satisfied because the first matching formula satisfies the safe harbor matching contribution requirement for the ADP safe harbor.

No ACP Safe Harbor for After-tax Employee Contributions

There is no safe harbor for after-tax employee contributions. Therefore, the ACP test still must be performed with respect to after-tax employee contributions made to the plan, even if the matching contributions satisfy the ACP safe harbor.[57]

Some plans offer a matching contribution on both elective contributions under the 401(k) arrangement and after-tax employee contributions. The plan will not fail to satisfy the ACP safe harbor with respect to the matching contributions merely because both types of contributions are matched.[58] However, that does not change the requirement that the after-tax employee contributions are still subject to the ACP test.

Applying the ACP Test Under a Safe Harbor 401(k) Plan

The following special rules apply if the ACP test has to be performed under a safe harbor 401(k) plan.

Testing Method

The plan must use the current year testing method.

Certain Matching Contributions Disregarded from ACP Test

The employer may elect to disregard the following matching contributions, so long as such contributions are disregarded for all eligible employees (HCEs and NHCEs):[59]

- All matching contributions may be disregarded, but only if the ACP test safe harbor is satisfied with respect to such contributions. A plan would be eligible for this exception if the ACP test is being run only because there are after-tax employee contributions.

EXAMPLE 5-37. Safe Harbor 401(k) Plan with After-tax Employee Contributions. A safe harbor 401(k) plan provides a matching contribution equal to 25 percent of the first 6 percent deferred. The plan satisfies the ADP safe harbor through a nonelective contribution. The plan also permits employees to make after-tax employee contributions. The matching contribution formula satisfies the formula requirements for the ACP safe harbor. However, because the plan allows after-tax employee contributions, an ACP test must be performed. The ACP test may be performed exclusively on the after-tax employee contributions or it may be performed by combining the matching contributions and after-tax employee contributions.

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[57] Treas. Reg. §1.401(m)-3(j)(6).
[58] Treas. Reg. §1.401(m)-3(d).
[59] Treas. Reg. §1.401(m)-2(a)(5)(iv).

- Matching contributions that do not exceed 4 percent of compensation may be disregarded, but only if the matching contributions satisfy the requirements of the basic formula or the enhanced formula under the ADP test safe harbor. The disregarding of matching contributions under this rule must be applied uniformly to all eligible employees.

EXAMPLE 5-38. Matching Contribution Meets ADP Safe Harbor But Not ACP Safe Harbor. A safe harbor 401(k) plan provides a matching contribution equal to 100 percent of the first 8 percent deferred. The matching contribution satisfies the safe harbor matching requirements under IRC §401(k) (12)(B) for the ADP safe harbor. There are no after-tax employee contributions permitted. Although the plan satisfies the ADP safe harbor requirements, the matching contribution formula fails to satisfy the ACP safe harbor because it matches contributions in excess of 6 percent of compensation.

An ACP test must be performed on the matching contributions. Because the matching formula satisfies the requirements for an enhanced formula under the ADP safe harbor, the employer may elect to disregard matching contribution that do not exceed 4 percent of compensation for purposes of the ACP test. In other words, the ACP test may be performed on all of the matching contributions, or just on the matching contributions that exceed 4 percent of compensation (or some lesser percentage of compensation that is applied uniformly to all eligible employees included in the ACP test).

- The employer may make QNECs to pass the ACP test. However, any nonelective contributions that are being made to satisfy the ADP safe harbor contribution requirement are not permitted to be treated as QNECs under the ACP test that has to be run on the matching contributions and/or after-tax employee contributions under the safe harbor 401(k) plan or under any other plan maintained by the employer.[60]

EXAMPLE 5-39. Safe Harbor Nonelective Contribution Cannot be Shifted to ACP Test. Suppose a plan provides for the safe harbor nonelective contribution of 3 percent to satisfy the ADP safe harbor and provides for a matching contribution that does not satisfy the ACP safe harbor. The safe harbor nonelective contributions may not be treated as QNECs under the ACP test that is applied to the matching contributions. However, if the safe harbor nonelective contribution equals 7 percent of compensation, rather than the statutory minimum of 3 percent, the additional 4 percent is eligible to be treated as QNECs under the ACP test.

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[60] Treas. Reg. §1.401(m)-2(a)(6)(vi).

- Elective deferrals under a 401(k) arrangement that relies on the ADP test safe harbor may not be included in the ACP test.[61] In other words, shifting of elective deferrals to the ACP test is not permitted.

If You're Curious …

ACP Safe Harbor Not Available to Thrift Plans

A defined contribution plan that provides for after-tax employee contributions and matches the after-tax employee contributions is sometimes known as a thrift plan. To satisfy the ACP test safe harbor with respect to its matching contributions, each NHCE in a defined contribution plan who is eligible to receive matching contributions under the plan must be an eligible employee under a 401(k) arrangement that satisfies the ADP test safe harbor.[62] This suggests that a thrift plan cannot use the ACP test safe harbor unless there is also a 401(k) arrangement either in that plan or in a separate plan that satisfies the ADP safe harbor and covers the participants who are eligible for matching contributions under the thrift plan. Furthermore, even if a thrift plan could use the ACP safe harbor with respect to matching contributions, the after-tax employee contributions would have to be ACP-tested.

Section 403(b) Plans

The ACP test safe harbor is available to 403(b) plans. To qualify for the ACP test safe harbor, the 403(b) plan must satisfy the following requirements:

1. the safe harbor contribution requirement under the ADP test safe harbor (even though the 403(b) plan is not subject to the ADP test);
2. the annual notice requirement under the ADP test safe harbor; and
3. the matching contribution limitations under the ACP test safe harbor.

Examples of Safe Harbor 401(K) Plan Designs

The following examples describe various plan designs and whether the ADP and/or ACP safe harbors are satisfied. In all of the examples, assume the contributions satisfy the 401(k) withdrawal restrictions and that the ADP safe harbor notice requirements are satisfied by the plan in any scenario in which the ADP safe harbor employer contribution requirements are satisfied.

EXAMPLE 5-40. Safe Harbor Nonelective Contribution Plus Matching Formula. A 401(k) plan provides a matching contribution equal to 25 percent of the first 6 percent deferred. The matching contribution is subject to a six-year graded vesting schedule. The employer makes a nonelective contribution of at least 3 percent of compensation. The nonelective contribution is 100 percent vested.

The 401(k)(12) safe harbor is satisfied because of the nonelective contributions. Furthermore, the matching contributions satisfy the ACP safe harbor because the plan

[61] Treas. Reg. §1.401(m)-2(a)(6)(ii).
[62] Treas. Reg. §1.401(m)-3(a).

satisfies the ADP safe harbor requirements (through the nonelective contribution), and the matching contribution formula applies only to the first 6 percent deferred and does not increase the rate of match as the rate of deferral increases.

EXAMPLE 5-41. Safe Harbor Nonelective Contribution Plus Tiered Matching Formula. A 401(k) plan provides a matching contribution equal to 100 percent of the first 3 percent deferred and 25 percent of the next 3 percent deferred. The matching contribution is 100 percent vested. The employer makes a nonelective contribution of at least 3 percent of compensation. The nonelective contribution is 100 percent vested.

The 401(k)(12) safe harbor is satisfied because of the nonelective contributions. The ADP safe harbor could not be satisfied on the basis of the matching contribution formula because, at a 4 percent or 5 percent deferral rate, the matching contribution is not large enough. However, the matching contribution still qualifies for the ACP safe harbor because the plan satisfies the ADP safe harbor (through the nonelective contributions), the matching contribution formula only applies to the first 6 percent deferred, and the rate of match does not increase as the rate of deferral increases (in fact, the rate of match decreases for elective contributions that exceed 3 percent of compensation).

EXAMPLE 5-42. Enhanced Safe Harbor Matching Contribution Formula Plus Discretionary Nonelective Contribution. A 401(k) plan provides a matching contribution equal to 100 percent of the first 4 percent deferred. The matching contribution is 100 percent vested. The plan permits the employer to make a discretionary nonelective contribution. The nonelective contribution is subject to a three-year cliff vesting schedule. The 401(k)(12) safe harbor is satisfied on the basis of the enhanced matching contribution formula. The matching contributions also satisfy the ACP safe harbor because they are allocated only on elective contributions that do not exceed 6 percent of compensation and the rate of match does not increase as the rate of deferral increases. Here, the matching contribution is being used to satisfy both the ADP safe harbor and the ACP safe harbor.

EXAMPLE 5-43. ADP Safe Harbor Not Satisfied; Matching Contribution Formula in Plan. A 401(k) plan provides a matching contribution equal to 50 percent of the first 6 percent deferred. The matching contribution is 100 percent vested. The plan permits the employer to make a discretionary nonelective contribution. The nonelective contribution is subject to a six-year graded vesting schedule.

The ADP safe harbor is not satisfied. Even though the matching contribution satisfies the vesting requirement, it is not large enough at each level of deferral to satisfy the ADP safe harbor matching contribution requirement. The nonelective contribution cannot be used to satisfy the safe harbor because it is discretionary and it is subject to a vesting schedule. Because the plan does not satisfy the ADP safe harbor, the matching contributions are not eligible for the ACP safe harbor, even though the matching formula satisfies the requirements of IRC §401(m) (11).

EXAMPLE 5-44. Matching Formula Provides Same Amount as Basic Safe Harbor Formula But Other ADP Safe Harbor Requirements Not Satisfied. The matching contribution formula under a 401(k) plan is discretionary. The matching contributions are 100 percent vested. The employer contributes 100 percent of the first 3 percent deferred and 50 percent of the next 2 percent deferred. There is no nonelective contribution.

The ADP safe harbor is not satisfied. Although the matching contributions are vested and satisfy the contribution levels, they are made under a discretionary contribution formula. Discretionary matching contributions cannot satisfy the ADP safe harbor, even if they are made at levels that would satisfy the safe harbor if the contributions were determined under a fixed formula. The matching contributions also would not be eligible for the ACP safe harbor because the plan does not satisfy the ADP safe harbor.

EXAMPLE 5-45. ADP Safe Harbor Satisfied; Matching Contributions are Discretionary. A 401(k) plan provides for a nonelective contribution that equals 3 percent of compensation and otherwise satisfies the ADP safe harbor requirements. The matching contribution formula is discretionary.

The plan satisfies the ADP safe harbor because of the nonelective contributions. The matching contributions will satisfy the ACP safe harbor, so long as the discretionary matching contributions are not permitted to exceed 4 percent of an eligible employee's compensation, the elective contributions that are matched do not exceed 6 percent of compensation, and the formula for allocating the matching contribution does not increase with the deferral rate or give a higher match to any HCE than is given to an NHCE.

EXAMPLE 5-46. ADP Safe Harbor and ACP Safe Harbor Satisfied; Plan Includes After-tax Employee Contributions. The matching contribution formula under a 401(k) plan is 50 percent of the first 4 percent deferred and 25 percent of the next 2 percent deferred. The matching contributions are subject to a four-year vesting schedule (25 percent per year). The plan provides a nonelective contribution of 3 percent of compensation that satisfies the requirements for the ADP safe harbor. The plan also permits after-tax employee contributions.

The plan satisfies the ADP safe harbor because of the nonelective contributions. The matching contributions satisfy the ACP safe harbor because the matching formula applies only to the first 6 percent deferred and does not increase the rate of match as the rate of deferral increases. However, the after-tax employee contributions are subject to the ACP test, because the ACP safe harbor does not apply to after-tax employee contributions.

EXAMPLE 5-47. Elective Contributions above 6 Percent of Pay are Matched. The matching contribution formula under a 401(k) plan is 50 percent of the first 8 percent deferred. The matching contributions are subject to a four-year vesting schedule (25 percent per year). The plan provides the safe harbor nonelective contribution of 3 percent of compensation.

The 401(k)(12) safe harbor is satisfied because of the nonelective contribution. The matching contributions do not satisfy the ACP safe harbor because elective contributions in excess of 6 percent of compensation are matched under the formula. An ACP test must

be performed on the matching contributions, but the ADP test does not have to be performed on the elective contributions.

COMPARISON OF MATCHING CONTRIBUTIONS UNDER THE ADP SAFE HARBOR AND THE ACP SAFE HARBOR

The following table summarizes the rules with respect to matching contributions under the ADP and ACP safe harbors:

Issue	Basic ADP Match	Enhanced ADP Match	ACP Match
Limited to matching elective contributions (or after-tax employee contributions) up to a certain percentage of compensation?	Yes (Only made on the first 5 percent of compensation deferred)	No	Yes (May only be made on the first 6 percent of compensation deferred)
Can rate of match increase as the rate of deferral increases?	No	No	No
Fixed formula required?	Yes (100% match on first 3% of compensation deferred plus 50% on next 2% of compensation deferred)	Yes (Not limited to specific matching contribution formula as with the basic ADP match)	No
Discretionary formula permitted?	No	No	Yes (Discretionary matching contributions may not exceed 4% of participant’s compensation)
Allocation conditions permitted?	No	No	No
Vesting schedule permitted?	No (always 100% vested)	No (always 100% vested)	Yes

5.06: Application of the Top-Heavy Rules to Safe Harbor 401(k) Plans

Safe harbor 401(k) plans are subject to the top-heavy rules, although a safe harbor 401(k) plan is deemed to be a non-top-heavy plan if the conditions of IRC §416(g)(4)(H) are satisfied.

GENERAL APPLICATION OF TOP-HEAVY RULES TO SAFE HARBOR 401(K) PLANS

Certain Safe Harbor 401(k) Plans Are Deemed Not to Be Top-Heavy

A safe harbor plan is deemed not to be a top-heavy plan (even if the top-heavy ratio, when calculated, exceeds 60 percent) if:

- the plan consists solely of a safe harbor 401(k) arrangement; or
- to the extent there are matching contributions made to the plan, all of the matching contributions satisfy the ACP safe harbor.[63]

Safe Harbor 401(k) Plans With Non-safe Harbor Contributions

If a safe harbor 401(k) plan provides contributions that do not constitute safe harbor contributions, top-heavy testing is required, and top-heavy minimum contributions may be needed for some or all of the non-key participants. If so, the ADP safe harbor nonelective contribution may be counted toward satisfying the top-heavy minimum contribution requirement. Therefore, if the safe harbor 401(k) plan satisfies the safe harbor contribution requirement through the nonelective contribution formula (but provides additional non-top-heavy contributions), the top-heavy minimum contribution liability is automatically being satisfied, unless the formula is using a definition of compensation that takes into account a lesser amount of compensation than the IRC §415 compensation. Note that the safe harbor nonelective contribution might be based on compensation for only a portion of the plan year (i.e., the employee is eligible for the 401(k) arrangement for only part of the year), whereas the top-heavy minimum contribution is always calculated on a participant's IRC §415 compensation for the entire plan year.[64]

Even if the safe harbor nonelective contribution is used to satisfy the top-heavy minimum contribution liability, it is still available to support nondiscrimination testing for other employer contributions. In other words, an employer may triple-dip with the ADP safe harbor nonelective contributions—once to enable the elective contributions under the 401(k) arrangement to qualify for the ADP safe harbor, a second time to satisfy the top-heavy minimum contribution obligation

[63] IRC §416(g)(4)(H).
[64] Treas. Reg. §1.416-1, M-7.

for the non-key employees and a third time to support IRC §401(a)(4) testing (other than permitted disparity) for other employer-provided benefits.

Matching contributions (even safe harbor matching contributions) also may be used to help satisfy top-heavy minimums.

Remember that some participants will not get the safe harbor match (i.e., they do not defer) or their matching contribution will not be enough to satisfy the entire top-heavy minimum contribution liability. In such case, the employer still will need to make additional contributions to satisfy the top-heavy minimum contribution, unless there are other allocations made for such participants to take care of the liability, or the deemed non-top-heavy rule described above applies.

EXAMPLE 5-48. Only Safe Harbor Nonelective Contributions Made. A safe harbor 401(k) plan provides for a 3 percent nonelective contribution to all participants who are eligible for the 401(k) arrangement. The nonelective contribution satisfies the 401(k)(12) safe harbor requirements. There are no other contributions, including allocations of forfeitures made to the plan for the plan year. The plan is deemed not to be top-heavy for the plan year, even if the top-heavy ratio of the plan exceeds 60 percent. This is true even if the definition of compensation for the safe harbor nonelective contribution is different than the IRC §415 compensation for the plan year.

Note that the primary consequence of being top-heavy is that a top-heavy minimum contribution must be provided to non-key employees. In a plan described in the above **EXAMPLE 5-48**, the nonelective contributions are 100 percent vested anyway, because immediate vesting is a condition of satisfying the 401(k)(12) safe harbor. Also, the 3 percent safe harbor nonelective contribution for most participants (and usually all participants) satisfies the 3 percent top-heavy minimum contribution. However, it is possible, because the compensation definition that is used to calculate the 3 percent safe harbor nonelective contribution might be different from the definition used to calculate the 3 percent top-heavy minimum, that this special rule may still reduce some of the contribution obligation the employer would have if the top-heavy rules were applicable.

EXAMPLE 5-49. Additional Nonelective Contributions Made. Suppose, in the prior **EXAMPLE 5-48**, that the employer also makes an additional nonelective contribution under the profit-sharing portion of the plan. Now the plan is subject to the top-heavy rules in the same manner as other 401(k) plans. However, the safe harbor nonelective contribution can be used to satisfy the top-heavy minimum to the extent that it meets the requirements.

Matching Contributions Under the Plan

Matching contributions under a safe harbor 401(k) plan might be made for the purpose of satisfying the safe harbor under IRC §401(k)(12), or they might be made in addition to the safe harbor contribution requirements. Regardless of whether matching contributions are made to satisfy the

IRC §401(k)(12), the deemed non-top-heavy rule applies only if all of the matching contributions satisfy the ACP safe harbor under IRC §401(m)(11).

EXAMPLE 5-50. Matching Contributions Used Only to Satisfy 401(k)(12) Safe Harbor. An employer maintains a safe harbor 401(k) plan. To make the plan a safe harbor, the employer makes a matching contribution in the amount of 100 percent of the first 4 percent deferred. The contribution is 100 percent vested. No other contributions are made to the plan. The matching contribution formula also satisfies the ACP safe harbor requirements under IRC §401(m)(11). Because the 401(k) arrangement is a safe harbor under IRC §401(k)(12), and the matching contributions satisfy the ACP safe harbor requirements under IRC §401(m)(11), this plan is deemed not to be top-heavy for the plan year.

The deemed non-top-heavy rule is more significant for an example like this one. Because the plan in this example is treated as not top-heavy, a non-key participant who chooses not to make elective contributions receives no employer contribution. Had the top-heavy rules applied, the employer would have to make the 3 percent top-heavy minimum contribution for any participant whose matching contributions do not equal at least 3 percent of compensation.

EXAMPLE 5-51. 401(k)(12) Safe Harbor Satisfied Through Nonelective Contributions, Matching Contributions Made in Addition to Nonelective Contributions. Suppose, in addition to the safe harbor nonelective contribution described in EXAMPLE 5-48, the employer makes a matching contribution equal to 50 percent of the first 6 percent deferred. The matching contribution formula satisfies the ACP safe harbor requirements of IRC §401(m)(11). Because the plan consists solely of a safe harbor 401(k) plan (which is a safe harbor because of the nonelective contribution) and the matching contributions under the plan satisfy the ACP safe harbor under IRC §401(m) (11), this plan is deemed not to be top-heavy for the plan year.

EXAMPLE 5-52. Match that Exceeds Amount Needed for 401(k) Safe Harbor Rule. All eligible employees under a 401(k) plan are provided a fixed matching contribution equal to 100 percent of the first 6 percent deferred. The contribution is 100 percent vested and otherwise satisfies the requirements of IRC §401(k)(12)(B). There are no nonelective contributions made to the plan.

Although the matching contribution is more than what is needed to make the 401(k) arrangement a safe harbor under IRC §401(k)(12), because the entire match also satisfies the ACP safe harbor requirements of IRC §401(m)(11), the plan is deemed not to be top-heavy for the plan year.

EXAMPLE 5-53. All or Portion of Match Fails to Satisfy ACP Safe Harbor. Let us return to EXAMPLE 5-50. Suppose, in addition to the match on the first 4 percent deferred, the employer makes a discretionary match. The discretionary match is capped at 6 percent of compensation. Although the 401(k) arrangement is a safe harbor under IRC §401(k)(12), the ACP safe harbor under IRC §401(m)(11) is not satisfied with respect to the discretionary match. This is because the ACP safe harbor requires a discretionary match to be capped at 4 percent of compensation. Because the matching contributions, considered in the aggregate, do not satisfy the ACP safe harbor, this plan is subject to the top-heavy rules in the same manner as other 401(k) plans. However, pursuant to IRC §416(c)(2)(A), the matching contributions may be used to satisfy the top-heavy minimum contribution obligation. Additional contributions may need to be made to the plan if the matching contribution amounts are not sufficient to satisfy the top-heavy minimum requirements.

The age-50 catch-up rule is a permissible feature in a safe harbor 401(k) plan. In addition, because catch-up contributions are treated like any other elective contributions, except as specifically provided by the statute, the inclusion of a catch-up contribution feature in a safe harbor 401(k) plan would not cause the top-heavy exemption to be lost. If the plan otherwise satisfies the requirements of the safe harbor exemption, it still would be deemed not to be a top-heavy plan even though catch-up contributions are made to the plan.

This treatment as a non-top-heavy plan does not apply if nonelective contributions are made to the plan unless the only nonelective contributions are those required to satisfy the 401(k) safe harbor.

Application of Aggregation Group Rules

Although a safe harbor 401(k) plan that satisfies the requirements described above is not treated as a top-heavy plan, there is nothing that precludes the plan from being part of an aggregation group [required aggregation group or permissive aggregation group, as described in IRC §416(g)(2)]. However, if the plan is part of a required aggregation group that is top-heavy, the safe harbor 401(k) plan is still treated as a non-top-heavy plan. In addition, employer contributions under the safe harbor 401(k) plan could still be taken into account to help one of the other plans in the top-heavy aggregation group satisfy the top-heavy minimum benefit requirements under IRC §416(c).[65]

EXEMPTION FROM TOP-HEAVY RULES DETERMINED ON A YEAR-BY-YEAR BASIS

The statutory requirement that the plan consist solely of a safe harbor 401(k) arrangement caused some initial confusion, particularly in the case of a plan which, in an earlier plan year, accepted discretionary employer contributions, or allocated forfeitures under a formula applicable to discretionary employer contributions. Because the determination of whether a plan is a top-heavy plan is made on a year-by-year basis, so is the determination of whether the safe harbor plan

[65] IRC §416(g)(4)(H).

exemption applies.[66] Thus, only the contributions and forfeiture allocations for the current plan year are taken into account to determine if the requirements of the exemption are satisfied for a particular year. If the requirements are not satisfied, then the plan is subject to the top-heavy rules for the plan year. If the requirements are satisfied, then the plan is exempt from the top-heavy rules for the plan year. The plan's status under the safe harbor plan exemption can change from year to year.

In the revenue ruling that clarifies the top-heavy rules for safe harbor plans, the IRS provides four scenarios, and explains whether the safe harbor exemption is satisfied. These scenarios are discussed below.

EXAMPLE 5-54. No Other Contributions or Forfeitures Although Discretionary Contributions are Authorized by Plan. Plan X is a profit-sharing plan with a 401(k) arrangement. The plan is designed to be a 401(k)(12) safe harbor plan. In this regard, the employer provides the safe harbor basic matching contribution to meet the ADP test. Although the plan also includes a provision that allows the employer to make a discretionary nonelective contribution, no discretionary contribution is made for the current plan year. However, discretionary contributions have been allocated in prior plan years. A five-year vesting schedule applies to the discretionary contributions, but no participants have incurred forfeitures for the current plan year. Thus, the only contributions made to the plan for the current plan year are elective contributions under the 401(k) arrangement and the safe harbor matching contribution, and no forfeitures have been allocated. The plan satisfies the safe harbor top-heavy exemption. The mere existence of a discretionary contribution formula does not trigger the application of the top-heavy rules.

EXAMPLE 5-55. Discretionary Contributions Actually Made. Assume the same facts as in **EXAMPLE 5-54** above, except the employer does make a discretionary contribution for the current plan year. Now the plan is not eligible for the safe harbor top-heavy exemption for the current plan year and may be considered top-heavy.

If You're Curious …

EXAMPLE 5-56. Separate Treatment for Otherwise Excludable Employees. Assume the same facts as in **EXAMPLE 5-54**, except employees are immediately eligible to make elective contributions under the 401(k) plan, but must complete one year of service to be eligible for an allocation of the safe harbor matching contributions. The only

[66] Rev. Rul. 2004-13.

contributions made for the current plan year are elective contributions under the 401(k) arrangement and the safe harbor matching contributions.

The plan is not eligible for the safe harbor top-heavy exemption. This is because the plan as a whole must satisfy the safe harbor rules. Because participants with less than one year of service are not eligible for the safe harbor matching contributions, the safe harbor 401(k) rules are not satisfied with respect to those participants. A plan may use the disaggregation rules applicable to otherwise excludable employees in this situation. The plan will satisfy the 401(k)(12) safe harbor for statutory employees and apply the ADP testing to the otherwise excludable employees. However, the plan is not disaggregated for purposes of the top-heavy rules. Thus, the failure to satisfy the 401(k)(12) safe harbor with regard to the otherwise excludable employees renders the entire plan subject to the top-heavy rules for that year.

If, for a particular plan year, a plan does not satisfy the requirements for the safe harbor plan exemption, the top-heavy rules are applied on the basis of the plan's top-heavy ratio determined for such plan year. Unless the plan year is the first year of the plan, that determination date is the last day of the prior plan year, even if the plan satisfied the safe harbor plan exemption in that prior year.

EXAMPLE 5-57. Top-heavy Determined on Year-by-Year Basis. A 401(k) plan has a plan year ending December 31. For the 2019 plan year, the only contributions made to the plan are elective contributions and the basic safe harbor matching contribution described. All eligible employees are eligible for the safe harbor matching contribution. The plan is exempt from the top-heavy rules for the 2019 plan year.

For the 2020 plan year, the employer makes a discretionary contribution, in addition to the safe harbor matching contribution. The plan is not exempt under safe harbor top-heavy exemption for the 2020 plan year. To determine if the plan is top-heavy for the 2020 plan year, the determination date is December 31, 2019.

Because the employer must make a 3 percent contribution to its top-heavy 401(k) plan, it should consider converting the plan to a safe harbor nonelective 401(k) plan. The changes to the plan might be very minimal. By making the same 3 percent contribution, but having it 100 percent vested and subject to the 401(k) withdrawal restrictions, the top-heavy minimum contribution is now enabling the plan to satisfy the ADP safe harbor. So, the same contribution cost eliminates the ADP test. Furthermore, there are the following additional considerations:

- If the plan provides for a match, the matching contribution may be used to reduce the employer's contribution liability under the top-heavy rules; and
- If the plan is converted to a safe harbor 401(k) plan under which the employer makes no contributions other than safe harbor contributions, the plan will be treated as a non-top-heavy plan after it is converted into a safe harbor 401(k) plan.

In contemplating a conversion to a safe harbor 401(k) plan, the employer should note that the safe harbor contributions might be allocable to more participants than those who would receive the top-heavy minimum contribution. For example, the top-heavy minimum contribution has to be provided only to non-key employees who are still

employed on the last day of the plan year.[67] The ADP safe harbor contribution (whether match or nonelective) would go to all NHCEs who are eligible to defer under the 401(k) arrangement. Usually the difference in contribution liability will not be significant, but the employer should be aware of this issue.

5.07: Permissible Reduction or Suspension of Safe Harbor Contributions

REDUCTION OR DISCONTINUANCE OF SAFE HARBOR MATCHING CONTRIBUTION

Rules in Effect for Plan Years Beginning On or After January 1, 2015

For plan years beginning on or after January 1, 2015, safe harbor matching contributions may be reduced or suspended mid-year only if one of the following requirements is met:

1. The employer is operating at an economic loss for the plan year; or
2. The safe harbor notice for the plan year states that the plan may be amended during the plan year to reduce or suspend safe harbor matching contributions, a supplemental notice will be provided if reduction or suspension occurs and the reduction or suspension will not apply until at least 30 days after the supplemental notice is provided.[68]

REDUCTION OR DISCONTINUANCE OF SAFE HARBOR NONELECTIVE CONTRIBUTION

In 2009, the Treasury proposed regulations that permitted the reduction or termination of the safe harbor nonelective contribution, primarily in response to financial hardships being experienced by many employers that sponsored safe harbor 401(k) plans. These regulations were finalized on November 15, 2013.

Under the final regulations, safe harbor nonelective contributions may be reduced or suspended mid-year if one of the following requirements is met:

1. The employer is operating at an economic loss for the plan year; or
2. The safe harbor notice for the plan year states that the plan may be amended during the plan year to reduce or suspend safe harbor nonelective contributions, a supplemental notice will be provided if reduction or suspension occurs and the reduction or suspension will not apply until at least 30 days after the supplemental notice is provided.[69]

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[67] Treas. Reg. §1.416-1, M-10.
[68] Treas. Reg. §1.401(k)-3(g)(1)(i).
[69] *Id.*

As is the case when the safe harbor matching contribution is suspended or reduced, if the plan reduces or eliminates the safe harbor nonelective contribution, it becomes subject to the ADP test and, if applicable, the ACP test, for such plan year. The ADP and ACP tests apply to all elective deferrals and matching contributions for the entire plan year, even elective deferrals and matching contributions made before the safe harbor contributions were discontinued or reduced. The reduction or discontinuance of the safe harbor contribution does not preserve the plan's safe harbor status, but it also does not cause the plan to fail to be qualified merely because the promised contribution will not be provided throughout the entire plan year.

Guidance issued under the QACA safe harbor permits the same option for sponsors providing safe harbor contributions under that alternative safe harbor rule.[70]

If the employer wants to reduce or suspend the safe harbor nonelective contribution before the end of the plan year, without having to terminate the 401(k) arrangement, certain conditions must be satisfied. The conditions are the same as the conditions described above for reducing or suspending the safe harbor matching contribution. If the conditions are satisfied, the following consequences apply:

1. ***Safe harbor contribution must be funded through date of reduction or suspension.*** The employer must fund the safe harbor contribution with respect to safe harbor compensation paid through the effective date of the reduction or suspension amendment, which must be at least 30 days after notice of the modification is given to the participants.[71] This funding requirement applies even though the plan still is subject to the ADP test for the entire plan year. For example, if employees are notified on July 25 that the nonelective contribution is discontinued effective September 1, the safe harbor nonelective contribution is made for safe harbor compensation paid through August 31;
2. ***Compensation limit must be prorated.*** When calculating the amount of an eligible employee's safe harbor nonelective contribution earned through the effective date of the amendment, the compensation dollar limit under IRC §401(a)(17) must be prorated to take into account the shortened period for which the contribution is being provided;[72] and
3. ***Top-heavy exemption revoked.*** Because the plan loses its safe harbor status for the plan year for which the safe harbor nonelective contribution is reduced or suspended, the plan is not entitled to rely on the top-heavy exemption under IRC §416(g)(4)(H). Thus, the plan is still required to satisfy the top-heavy minimum contribution requirement for the entire plan year if the plan is otherwise top heavy. If the employer has to make a 3 percent contribution for the entire year to satisfy the top-heavy rules, there may be little or no savings, as compared to the safe harbor nonelective contribution that would have been calculated for the plan year if the contribution had not been reduced or suspended. This may be a reason for the employer to terminate the 401(k) arrangement, rather than merely discontinue or reduce the safe harbor nonelective contribution. Under the rules for plan terminations, if the 401(k) arrangement terminates, and the employer incurs a substantial business hardship, the plan retains its safe harbor status for the plan year in which the arrangement terminates, enabling

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[70] Treas. Reg. §1.401(k)-3(a)(2).
[71] Treas. Reg. §1.401(k)-3(g)(1)(ii).
[72] Treas. Reg. §1.401(a)(17)-1(b)(3)(iii)(A).

the plan to retain its top-heavy exemption if the only contributions made by the employer for that year are safe harbor contributions.[73]

If You're Curious …

Operating at Economic Loss for Purposes of Reduction of Suspension of Safe Harbor Contribution Prior to the Final Regulations

The proposed regulations' rule requiring substantial business hardship refers to the definition of this term that is used in IRC §412 in relation to waivers of minimum funding for pension plans. In particular, IRC §412(c)(2) lists the following factors as relevant to a determination of a substantial business hardship:

1. the employer is operating at an economic loss;
2. there is substantial unemployment or underemployment in the trade or business and in the industry concerned;
3. the sales and profits of the industry concerned are depressed or declining; and
4. it is reasonable to expect that the plan will not continue unless the amendment is adopted.

The regulation refers to the "employer" having a substantial business hardship. Under the Treasury regulations related to 401(k) plans, the term "employer" means the employer maintaining the plan and those employers required to be aggregated with the employer under IRC §414(b), (c), (m), or (o). This presumably then means that all members of the employer's related group must satisfy the business hardship condition.[74]

5.08: Review of Key Concepts

- What is the difference between a 401(k)(12) safe harbor and a 401(k)(13) or QACA safe harbor?
- Define a QACA.
- Explain the automatic deferral requirements applicable to a QACA.
- What are the four conditions a safe harbor 401(k) plan must satisfy to avoid ADP testing?
- Name the two types of contributions that satisfy the ADP safe harbor requirements.
- Describe the 401(k)(12) safe harbor basic and enhanced matching contribution formulas.
- Describe the QACA safe harbor basic and enhanced matching contribution formulas.
- Describe the ADP safe harbor nonelective contribution formula.
- What are the timing requirements for implementing safe harbor provisions in new and existing plans?
- Describe the wait-and-see approach.

[73] Treas. Reg. §1.401(k)-3(e)(4)
[74] Treas. Reg. §§1.401(k)-6, 1.410(b)-9.

- When can a safe harbor contribution be discontinued and what are the consequences?
- Describe the content and timing requirements for the annual 401(k)(12) and QACA safe harbor notices.
- What conditions must be satisfied to qualify for the ACP safe harbor?
- Describe the rules that apply if the ACP test is performed in a plan that satisfies the ADP safe harbor requirement.
- How do the top-heavy rules apply to safe harbor 401(k) plans?

5.09: For Practice – True or False

1. The safe harbor nonelective contribution must be at least 3 percent of compensation to satisfy the ADP safe harbor requirement.
2. A plan can satisfy the ACP safe harbor without satisfying the ADP safe harbor.
3. A plan that provides for a discretionary matching contribution that does not exceed 6 percent of compensation satisfies the ADP and ACP safe harbor requirements.
4. A profit-sharing plan that has never had a 401(k) arrangement can add provisions to become a safe harbor 401(k) plan as long as the amendment is effective at least three months before the end of the current plan year.
5. A plan that uses matching contributions to meet the ADP safe harbor does not satisfy top-heavy minimum contribution requirements.
6. A 401(k) plan that uses the safe harbor nonelective contribution to satisfy the ADP safe harbor requirements may exclude participants who are not employed on the last day of the plan year from receiving an allocation.
7. A plan may not exclude HCEs from receiving a safe harbor contribution allocation.
8. Safe harbor matching contributions may be based on the plan year or on a payroll period basis.
9. Contributions used to satisfy the ADP safe harbor requirement must be 100 percent vested at all times.
10. Contributions used to satisfy the ADP safe harbor may be available for hardship withdrawal, effective with the 2019 plan year.
11. The lowest automatic enrollment percentage in a QACA safe harbor is 3 percent of compensation.

5.10: Sample Test Questions

1. All of the following statements regarding safe harbor 401(k) plans are TRUE, EXCEPT:

   A. The employer must provide either a minimum matching contribution or a minimum nonelective contribution.
   B. The employer may adopt a provision that postpones the decision to make a safe harbor non-elective contribution until 30 days before the plan year end.
   C. The safe harbor contribution must be subject to 401(k) withdrawal restrictions.
   D. The employer must provide participants with an annual written notice explaining the safe harbor provisions.
   E. Safe harbor 401(k) plans may not be stopped mid-year.

2. All of the following statements regarding the ADP safe harbor are TRUE, EXCEPT:

   A. The matching contribution used to satisfy the ADP safe harbor may not be used to satisfy the ACP safe harbor.
   B. Generally, the plan year must be at least three months long to qualify as a safe harbor plan.
   C. The safe harbor contribution could be made to a separate defined contribution plan.
   D. The safe harbor contribution must be required by the plan.
   E. IRC §414(s) compensation must be used to calculate safe harbor contributions.

3. All of the following formulas satisfy the ADP safe harbor requirements, EXCEPT:

   A. Nonelective contribution of 3 percent of compensation
   B. Matching contribution of 100 percent on the first 6 percent deferred
   C. Matching contribution of 100 percent on the first 3 percent deferred and 50 percent on the next 2 percent deferred
   D. Matching contribution of 100 percent on the first 3 percent deferred and 125 percent on the next 2 percent deferred
   E. Nonelective contribution of 5 percent of compensation

4. All of the following formulas satisfy the QACA safe harbor requirements, EXCEPT:

   A. Matching contribution of 100 percent on the first 4 percent deferred
   B. Matching contribution of 100 percent on the first 3 percent deferred plus 50 percent on the next 2 percent deferred
   C. Nonelective contribution of 3 percent of compensation
   D. Matching contribution of 100 percent on the first 1 percent deferred plus 50 percent on the next 5 percent deferred
   E. Matching contribution of 50 percent on the first 7 percent deferred

5. All of the following statements regarding safe harbor 401(k) plans and top-heavy requirements are TRUE, EXCEPT:

   A. Safe harbor nonelective contribution may be used to satisfy top-heavy minimum contribution requirements.
   B. Discretionary matching contributions will cause a safe harbor 401(k) plan to lose the deemed not-top-heavy exemption.
   C. Safe harbor matching contributions may be used to satisfy top-heavy minimum contribution requirements.
   D. A plan that consists solely of a safe harbor 401(k) arrangement may be deemed not top-heavy.
   E. A plan that is deemed not top-heavy may still be part of a required aggregation group.

6. Which of the following statements regarding the ACP safe harbor is/are TRUE?

   I. A plan must pass the §401(k)(12) ADP safe harbor with respect to its elective deferrals in order to use the IRC §401(m)(11) ACP safe harbor with respect to its matching contributions.
   II. The rules for IRC §401(k)(12) ADP safe harbor matching contributions are the same as the rules for IRC §401(m)(11) ACP safe harbor matching contributions.

III. The ACP test must be performed on any after-tax employee contributions made to the plan even if the plan's matching contributions satisfy the IRC §401(m)(11) ACP safe harbor.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

7. Which of the following statements regarding safe harbor 401(k) plans is/are TRUE?

I. It is permissible for a plan to use the §401(k)(12) ADP safe harbor with respect to its elective deferrals and also have matching contributions that are subject to the ACP test.
II. A plan may satisfy the IRC §401(k)(12) ADP safe harbor by using the three percent safe harbor nonelective contribution and have a matching contribution that satisfies the IRC §401(m)(11) ACP safe harbor.
III. A plan may satisfy the IRC §401(k)(12) ADP safe harbor by using the safe harbor enhanced matching contributions and have an additional matching contribution that satisfies the IRC §401(m)(11) ACP safe harbor.

B. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

8. Which of the following statements regarding safe harbor 401(k) plans is/are TRUE?

I. A new plan may not be a safe harbor plan for the first plan year unless the first plan year is at least six months long.
II. A plan may be amended to discontinue a safe harbor matching contribution for the rest of the plan year and run ADP/ACP testing for that year instead.
III. A safe harbor notice can be given up to the first day of the first plan year of a newly established safe harbor 401(k) plan.

C. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

9. Which of the following is/are required to be in the annual notice for a safe harbor 401(k) plan?

I. The withdrawal provisions applicable to contributions in the plan
II. The investment options applicable to the contributions in the plan
III. The periods available under the plan for making a cash or deferred election

D. I only

B. II only
C. I and III only
D. II and III only
E. I, II and III

10. Which of the following statements regarding safe harbor 401(k) plans is/are TRUE?

    I. A partial year ADP and/or ACP test must be run if safe harbor contributions are discontinued mid-year.
    II. A plan that discontinues safe harbor contributions mid-year is not entitled to rely on the top-heavy exemption for that year.
    III. Safe harbor matching contributions may only be reduced or suspended mid-year if the employer is operating at an economic loss for the plan year.

E. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

5.11: Solutions to True or False Questions

1. True.
2. False. A plan satisfying the ADP safe harbor may or may not satisfy the ACP safe harbor, but can never satisfy the ACP safe harbor without also satisfying the ADP safe harbor. In other words, satisfying the ADP safe harbor is a condition for satisfying the ACP safe harbor.
3. False. Discretionary matching contributions are eligible for the ACP safe harbor as long as they do not exceed 4 percent of compensation.
4. True.
5. False. A safe harbor 401(k) plan that satisfies the ADP safe harbor with matching contributions may satisfy top-heavy minimum requirements.
6. False. Conditions like last-day employment are not allowed for safe harbor contributions.
7. False. Safe harbor contributions must be available to all NHCEs. HCEs may be excluded.
8. True.
9. True.
10. True.
11. True.

5.12: Solutions to Sample Test Questions

1. The answer is **E**. Safe harbor 401(k) plans may be amended to discontinue safe harbor contributions during the plan year.
2. The answer is **A**. A matching contribution that satisfies the ADP safe harbor may be used to satisfy the ACP safe harbor.
3. The answer is **D**. The matching contribution used to satisfy the ADP safe harbor may not increase as the rate of deferral increases.
4. The answer is **E**. This formula will not satisfy the QACA safe harbor because it does not match contributions on the first 1 percent of compensation deferred dollar-for-dollar.
5. The answer is **B**. If the discretionary matching contribution satisfies the ACP safe harbor, the plan may still qualify for deemed not-top-heavy status.
6. The answer is **C**. The rules for IRC §401(k)(12) ADP safe harbor matching contributions are not the same as the rules for IRC §401(m)(11) ACP safe harbor matching contributions.
7. The answer is **E**. All of the statements are true.
8. The answer is **D**. A new plan may not be a safe harbor plan for the first plan year unless the first plan year is at least three months long and the 401(k) arrangement is in effect for at least three months for that first year.
9. The answer is **C**. Plan investment options are not required to be included in the safe harbor notice.
10. The answer is **B**. A full year ADP and/or ACP test must be run if safe harbor contributions are discontinued mid-year. For plan years beginning on or after January 1, 2015, safe harbor matching contributions may be reduced or

suspended mid-year if the employer is operating at an economic loss for the plan year or if the safe harbor notice contains certain information regarding the potential for reduction or suspension of the safe harbor matching contributions.

CHAPTER 6:

PARTICIPANT INVESTMENT DIRECTION

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6.01: Key Terms

- Blackout notice
- Blackout period
- Core investments
- Fiduciary
- Frequency rule
- Individual account plans
- Investment advice
- Look-through investment
- Mapping
- Participant-directed plan
- Qualified default investment alternative (QDIA)

6.02: Introduction

A common feature in defined contribution plans is participant-directed investments. When a plan allocates investment responsibility to participants, a fiduciary is required under the exclusive purpose rule of ERISA §404(a)(1)(A) and the prudence rule under ERISA §404(a)(1)(B) to take steps to ensure that such participants and beneficiaries are made aware of their rights and responsibilities with respect to the investment of assets held in their accounts. In addition, ERISA §404(c) offers relief to fiduciaries with respect to participant-directed accounts.

Although this discussion makes references to participant-directed accounts, the right to direct investments also may be given to a beneficiary under the plan. A beneficiary would include a person entitled to receive benefits of a deceased participant, as well as an alternate payee under a qualified domestic relations order (QDRO). Whether beneficiaries are entitled to direct investments is governed by the plan document (and any applicable written procedures regarding the right to direct investments). From the fiduciary's standpoint, ERISA §§ 404(a) and (c) are equally applicable to investments directed by active participants, terminated participants and beneficiaries. Therefore, the discussions in this chapter that refer to the participant apply equally to beneficiaries that are permitted to self-direct their investments.

6.03: Participant Disclosures

DOL Reg. §§2550.404a-5 and 2550.404c-1 require fiduciaries to make certain disclosure to participants and beneficiaries who are permitted to direct investments in a defined contribution plan.[426] These disclosures need to be made on a regular and periodic basis, as outlined in the regulations. Sufficient information must be provided, including information about fees and expenses, so that participants and beneficiaries can make informed decisions regarding the management of their individual accounts.[427] The required disclosures include:

- General plan-related information (at least annually);
- General information on administrative expenses (at least annually);
- General information about individual expenses that may be charged to a participant's account (at least annually);

[426] DOL Reg. §2550.404a-5(j)(2).
[427] DOL Reg. §2550.404a-5(a).

- Specific information about the administrative expenses and individual expenses actually charged to the participant's account (at least quarterly); and
- Investment-related information (some mandatory, some upon request).

The disclosures are required as part of the fiduciary's obligations under ERISA §404(a), regardless of whether the plan satisfies or attempts to satisfy the requirements for relief under ERISA §404(c). ERISA §404(c) will be discussed later in this chapter.

COVERED PLANS

A plan is a "covered individual account plan" (i.e., is subject to these disclosure requirements) if the plan is a participant-directed individual account plan as defined in ERISA §3(34). There is no exception for small plans (e.g., plans that have fewer than 100 participants), although there are no disclosure obligations if the plan covers only owners and their spouses. The regulations do not apply to defined contribution plans that do not allow participants to direct investments. A plan administrator must provide disclosures to each participant. An eligible participant under the plan is entitled to these disclosures even if he/she is not deferring compensation into the plan. This is true even if the only participant-directed investments allowed under the plan are those pertaining to elective contributions. Such a participant is still entitled to the disclosures because the participant might later decide to start deferring into the plan and the fee information may be a factor in that decision (or in the level of contributions the participant elects to make).

Beneficiaries, alternate payees under a QDRO and terminated participants must receive the disclosures only if they actually have an account balance with respect to which they are entitled to direct investments.

Exception for 403(b) Plans and IRA-Funded Arrangements

Simplified Employee Pensions (SEPs), as defined in IRC §408(k), and SIMPLE IRA retirement accounts, as defined in IRC §408(p), are not subject to these regulations.[428]

Section 403(b) plans are subject to these regulations only if they are ERISA-covered participant-directed individual account plans. 403(b) plans maintained by a governmental entity or by a church that has not elected to be subject to ERISA are not subject to these regulations. Also, a 403(b) plan offered by a nongovernmental, non-church, entity (e.g., a plan offered by a private college), that is not considered to be "maintained" by the employer because of the employer's limited involvement with the plan is not an ERISA-covered plan.[429]

GENERAL PLAN-RELATED INFORMATION TO BE DISCLOSED

General plan information consists of information about the structure and mechanics of the plan. This information includes:

3. an explanation of the circumstances under which investment instructions may be given;

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[428] DOL Reg. §2550.404a-5(b)(2).
[429] DOL Reg. §2510.3-2(f).

4. an explanation of any specified limitations on such instructions (e.g., restrictions on transfer to or from a designated investment alternative);
5. a description of (or reference to) plan provisions relating to the exercise of voting, tender and similar rights applicable to an investment in a designated investment alternative, as well as any restrictions on such rights;
6. an identification of each designated investment alternative offered under the plan;
7. an identification of any designated investment managers; and
8. a description of any brokerage window, self-directed brokerage account or similar arrangement that enables a participant or beneficiaries to select investments beyond those designated by the plan.[430]

The DOL intends that the disclosure include only plan-based limitations and restrictions on a participant's ability to direct investments or transfer to or from designated investment alternatives. To the extent any limitations or restrictions are imposed at the investment, fund or portfolio level, those limitations or restrictions would be included in the investment-related disclosures discussed below.

GENERAL ADMINISTRATIVE EXPENSES

The plan administrator must provide to participants and beneficiaries at least annually an explanation of any fees and expenses for plan administrative services (such as legal, accounting, recordkeeping) that may be charged against their individual accounts and are not reflected in the total annual operating expenses of any designated investment alternative. The disclosure must also include the basis on which such charges will be allocated to, or affect the balance of, each individual account (e.g., pro rata, per capita).[431] Investment-related fees and expenses (such as expense ratios) are the subject of separate disclosure requirements discussed below.

The regulations are intended to ensure that participants and beneficiaries are informed about the plan's day-to-day operational expenses that will be charged against their accounts.

Specific Amount Allocated to Each Account

On at least a quarterly basis, the plan administrator must provide participants and beneficiaries with a statement that specifies plan administrative fees and expenses actually deducted from their accounts, as well as a description of the services to which such fees and expenses relate. If applicable, the statement must include an explanation that, in addition to the fees and expenses shown, some of the plan's administrative expenses were paid out of the total annual operating expenses of one or more of the plan's designated investment alternatives (e.g., through revenue sharing, such as 12b-1 fees or subtransfer agency fees).[432]

The disclosure must be specific enough to enable participants to distinguish the administrative services from other charges and services that may be assessed against the account. It is not necessary to have the charges broken out and listed on a service-by-service basis. An identification of an aggregate dollar amount of the total administrative fees and expenses assessed during the

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[430] DOL Reg. §2550.404a-5(c)(1)(i).
[431] DOL Reg. §2550.404a-5(c)(2)(i)(A).
[432] DOL Reg. §2550.404a-5(c)(2)(ii).

quarter, with an indication that the charges include legal, accounting, and recordkeeping costs, is sufficient.[433]

INDIVIDUAL EXPENSES

At least annually, the plan administrator must furnish an explanation of any fees and expenses that may be charged to accounts for services provided on an individual basis.[434] Examples include loan processing fees, fees related to the review of qualified domestic relations orders (QDROs) issued against the participant and investment advisory fees.

Specific Amount Allocated to Each Account

On at least a quarterly basis, participants and beneficiaries must receive a statement that includes the dollar amount of individual fees and expenses actually charged to their account (whether by liquidating shares or deducting dollars) during the preceding quarter and a description of the services (such as, loan processing) to which such charges relate.[435]

TIMING RULES AND UPDATING OF CHANGES IN INFORMATION

The initial and annual disclosures above must be provided to a participant or beneficiary on or before the date on which he or she can first direct the account investments and at least annually thereafter.[436] "At least annually" means that the annual notice must be given within 14 months of the prior year's disclosure.[437] This allows plan administrators some leeway to provide the notice at approximately the same time each year.

Use of Most Recently Furnished Annual Disclosure Statements

The initial disclosure requirements for participants or beneficiaries who become eligible to receive them may be the most recent annual disclosure furnished to participants and beneficiaries by the plan administrator, plus any updates to the information that has been furnished since that most recent annual disclosure.[438]

The annual disclosure requirements may be provided as part of the plan's summary plan description (SPD) or as part of a participant's quarterly employee benefit statement if the SPD or benefit statement is furnished frequently enough to comply with the timing rules.[439] For example, an employer that provides the SPD at least once in a 14-month period may incorporate the annual disclosures as part of the SPD. Similarly, the employer might furnish the annual information with

[433] 75 F.R. 64913 (footnote 8).
[434] DOL Reg. §2550.404a-5(c)(3)(i).
[435] DOL Reg. §2550.404a-5(c)(2)(ii).
[436] DOL Reg. §§2550.404a-5(c)(1)(i), 2550.404a-5(c)(2)(i)(A) and 2550.404a-5(c)(3)(i)(A).
[437] DOL Reg. §2550.404a-5.
[438] DOL Reg. §2550.404a-5(c)(4).
[439] DOL Reg. §2550.404a-5(e)(1).

one of the four quarterly benefit statements each year as long as there is no more than a 14-month period between the furnishing of the information.

The quarterly disclosure requirements described above are satisfied if the information is provided at least once in any three-month period, without regard to whether the plan operates on a calendar year or fiscal year basis.[440] The initial quarterly disclosures are due 45 days after the end of the quarter in which the initial disclosures are required.[441]

The information that must be provided quarterly may be included as part of the quarterly benefit statement, or may be a separate disclosure document.[442]

Requirement to Update Information

If there is a change to the information described above, each participant and beneficiary must be furnished a description of the change between 30 and 90 days in advance of the effective date of such change.[443] However, if the inability to provide such advance notice is due to events that were unforeseeable or circumstances beyond the control of the plan administrator, notice of such change must be furnished as soon as reasonably practicable.

INVESTMENT INFORMATION

The required investment information is divided into three categories:

- information to be provided automatically;
- voting rights information to be provided subsequent to investment; and
- information to be provided upon request.

Automatically-Provided Investment Information

On or before the date on which a participant or beneficiary is first able to direct his/her investments, and at least annually thereafter, the plan administrator (or its designee) must furnish with respect to each designated investment alternative offered under the plan, the information described below, based on the latest information available to the plan.[444] The format for this disclosure must be a comparative chart, so that the participants may easily discern the differences between the various investments.

The DOL provides a model chart in an appendix to the regulations. Use of the model chart is not required, but a fiduciary that uses and accurately completes the model is deemed to meet the formatting requirement of the regulations.[445] A plan may develop its own chart or similar disclosure format, if desired.

The deadline for this disclosure is the same as for the annual disclosure discussed above. Where indicated, the information will differ between investment alternatives that have a fixed or stated

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[440] DOL Reg. §2550.404a-5(h)(2).
[441] DOL Reg. §2550.404a-5(j)(3)(i)(B).
[442] DOL Reg. §2550.404a-5(e)(2).
[443] DOL Reg. §§2550.404a-5(c)(1)(ii), 2550.404a-5(c)(2)(i)(B) and 2550.404a-5(c)(3)(i)(C)).
[444] DL Reg. §2550.404a-5(d)(1).
[445] DOL Reg. §2550.404a-5(e)(3).

return for the term of the investment and investment alternatives that do not have a fixed or stated return. For purposes of the discussion below, we refer to these categories as "fixed-return investments" and "variable-return investments," respectively. Each participant or beneficiary must receive the full comparative chart, regardless of the investments such individual has actually selected for the account.

The comparative chart for variable-return investments must contain the following elements:

a. identifying information including the name of the investment and the type or category of the investment;
b. performance data including average annual total return for 1-year, 5-years and 10-years (if applicable), along with a statement that an investment's past performance is not necessarily an indication of how the investment will perform in the future;
c. benchmark information (i.e., the name and returns of an appropriate broad-based securities market index over the applicable performance periods);
d. fee and expense information (such as the amount and a description of each shareholder-type fee, expense ratios, a statement indicating that fees and expenses are only one of several factors that should be considered when making investment decisions and a statement that the cumulative effect of fees and expenses can substantially reduce the growth of a participant's or beneficiary's retirement account); and
e. reference to an Internet website address that is sufficient to lead the individual to access specific information regarding each type of designated investment alternative.

The comparative chart for fixed-return investments must contain the following elements:

- identifying information including the name of the investment and the type or category of the investment;
- performance data (such as the fixed rate of return and the term of the investment);
- fee and expense information (such as the amount and a description of any shareholder-type fee that may be applicable to a purchase, transfer or withdrawal of the investment in whole or in part); and
- reference to an Internet website address that is sufficient to lead the individual to access specific information regarding each type of designated investment alternative.

Benchmark information is not required for fixed-return investments.[446]

Additional Information

The comparative investment chart must also include:

1. a statement indicating the name, address, and telephone number of the plan administrator (or designee) to contact for voting rights information, required to be provided subsequent to investment;
2. a statement that additional investment-related information (including most current performance information) is available at the listed Internet website address(es) described above; and

[446] DOL Reg. §2550.404a-5(d)(1), 2550.404a-5(i) and 2550.404a-5(h)

3. a statement explaining how to request and obtain, free of charge, paper copies of the information required to be made available through a website as described above.[447]

A fiduciary may provide additional information in the comparative chart, provided such information is not inaccurate or misleading.[448] Nothing in the regulations precludes plan administrators from combining multiple documents for purposes of satisfying their obligation to provide the information required by comparative format rule. For example, a chart could be divided such that one part presented stock funds while another part presented bond funds, as in the DOL's model format. Similarly, a chart could group investment alternatives by issuer. On the other hand, individual investment issuers, or others, may not separately distribute comparative charts reflecting their particular investment alternatives, because such an approach would not be furnishing information in a form that would facilitate a comparison of the required investment information.[449]

Glossary of Terms

To assist participants and beneficiaries in understanding the designated investment alternatives, the required disclosures must include a general glossary of terms, or an Internet website address that is sufficiently specific to provide access to such a glossary, along with a general explanation of the purpose of the website address.[450]

If You're Curious …

Special Disclosure Rule for Employer Securities

If the plan is designed to invest in, or primarily in, qualifying employer securities (within the meaning of ERISA §407), the disclosures are different. In lieu of information on principal strategies and risks, the automatic investment disclosure must provide an explanation of the importance of a well-balanced portfolio, information relating to portfolio turnover rate does not apply and fee and expense information does not apply unless the designated investment alternative is a unitized fund.[451]

Special Disclosure Rule for Annuity Options

In the case of a designated investment alternative that is a contract, fund or product that permits participants or beneficiaries to allocate contributions toward the current purchase of a stream of retirement income payments guaranteed by an insurance company, the following information is required in the automatic investment disclosure in lieu of the information described above:

1. the name of the contract, fund or product;
2. the option's objectives or goals (e.g., to provide a stream of fixed retirement income payments for life);

[447] DOL Reg. §2550.404a-5(d)(2)(i).
[448] DOL Reg. §2550.404a-5(d)(2)(ii).
[449] Preamble to the regulations at 75 F.R. 64922.
[450] DOL Reg. §2550.404a-5(d)(1)(vi).
[451] DOL Reg. §2550.404a-5(i)(1).

3 the benefits and factors that determine the price (e.g., age, interest rates, form of distribution) of the guaranteed income payments;
4. any limitations on the ability of a participant or beneficiary to withdraw or transfer amounts allocated to the option (e.g., lock-ups) and any fees or charges applicable to such withdrawals or transfers;
5. any fees that will reduce the value of amounts allocated by participants or beneficiaries to the option, such as surrender charges, market value adjustments and administrative fees;
6. a statement that guarantees of an insurance company are subject to its long-term financial strength and claims-paying ability and the website information described in the next paragraph.[452]

The information for the annuity option must include a reference to an Internet website address that is sufficiently specific to provide participants and beneficiaries access to:

1. the name of the contract, fund or product;
2. the option's objectives or goals (e.g., to provide a stream of fixed retirement income payments for life);
3. any limitations on the ability of a participant or beneficiary to withdraw or transfer amounts allocated to the option (e.g., lock-ups) and any fees or charges applicable to such withdrawals or transfers;
4. any fees that will reduce the value of amounts allocated by participants or beneficiaries to the option, such as surrender charges, market value adjustments and administrative fees;
5. a description of the option's distribution alternatives/guaranteed income payments (e.g., payments for life, payments for a specified term, joint and survivor payments, optional rider payments), including any limitations on the right of a participant or beneficiary to receive such payments; and
6. a description of costs and/or factors taken into account in determining the price of benefits under an option's distribution alternatives/guaranteed income payments (e.g., age, interest rates, other annuitization assumptions).[453]

Additional Information Relating to Target Date-type Funds

The DOL reserved Reg. §2550.404a-5(i)(4) for later dissemination of guidance pertaining to investment-related disclosures for target date-type funds. That guidance was proposed on November 30, 2010. Under the proposal, for any designated investment alternative that is a target-date fund, the following information would be required as an appendix or appendices to the comparative chart or similar document prescribed by DOL Reg. §2550.404a-5(d)(2):

1. an explanation of the asset allocation, how the asset allocation will change over time and the point in time, when the QDIA will reach its most conservative asset allocation, including a chart, table or other graphical representation that illustrates such change in asset allocation over time and that does not obscure or impede a participant's or beneficiary's understanding of this information;
2. If the QDIA is named, or otherwise described, with reference to a particular date (e.g., a target date), an explanation of the age group for whom the investment is

[452] DOL Reg. §2550.404a-5(i)(2).
[453] DOL Reg. §2550.404a-5(i)(2)(vii).

designed, the relevance of the date, and any assumptions about a participant's or beneficiary's contribution and withdrawal intentions on or after such date; and

3. applicable, a statement that the participant or beneficiary may lose money by investing in the QDIA, including losses near and following retirement, and that there is no guarantee that the investment will provide adequate retirement income.[454]

Voting Rights Information to Be Provided Subsequent to Investment

Subsequent to an investment in a designated investment alternative with respect to which voting, tender or similar rights are passed through to the participant or beneficiary, the individual must be furnished any materials provided to the plan relating to the exercise of such rights.[455]

Information Provided Upon Request

The plan administrator must furnish the following if a participant or beneficiary so requests:

a. copies of prospectuses (or any short-form or summary prospectus approved by the SEC) for the disclosure of information to investors by entities registered under the Securities Act of 1933 or the Investment Company Act of 1940, or similar documents relating to alternatives that are provided by entities that are not registered under either Act;
b. copies of any financial statements or reports (e.g., statement of additional information, shareholder reports) that are provided to the plan;
c. a statement of the value of a share or unit of each designated investment alternative and the date of the valuation; and
d. a list of the assets comprising the portfolio of each designated investment alternative which constitute plan assets within the meaning of DOL Reg. §2510.3-101 (e.g., a collective investment fund) and the value of each such asset (or the proportion of the investment which it comprises).[456]

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[454] Prop. DOL Reg. §2550.404a-5(i)(4).
[455] DOL Reg. §2550.404a-5(d)(3).
[456] DOL Reg. §2550.404a-5(d)(4).

If desired, a plan administrator is permitted to make any of these disclosures as part of the automatic investment disclosure, rather than only upon request.

MISCELLANEOUS DISCLOSURE REQUIREMENTS

Manner of Expressing Fees

Except for the specific dollar amount disclosures described in the general administrative expense disclosure rules and individual expense disclosure rules at the beginning of the chapter, fees and expenses may be expressed in terms of a monetary amount, formula, percentage of assets or per capita charge.[457]

Understandability

The required disclosures must be written in a manner calculated to be understood by the average plan participant.[458]

Electronic Delivery

Any manner of delivery permitted under DOL Reg. §2520.104b-1, including the use of electronic media, may be used to comply with these disclosure requirements.[459] The DOL issued electronic delivery guidance in Technical Release 2011-03R. In general, the DOL guidance on electronic disclosure is considered by most to be too restrictive for practical use and many have appealed to the DOL for a more practical approach. However, in October of 2019, the DOL released proposed regulations that create a new safe harbor for electronic delivery (while retaining the current rules). Under the proposed rule, the plan administrator may post disclosures to a designated website as long as they can confirm the email address of the participant. Note that the participant would be given a paper notice at the outset of this practice and could decline electronic disclosure and receive the disclosure in paper form for no charge.

Duties Regarding Selection and Monitoring

These disclosure requirements do not relieve a fiduciary from its duty to prudently select and monitor service providers to the plan or designated investment alternatives offered by the plan.[460] Similarly, the relief provisions under ERISA §404(c) do not relieve a fiduciary from its duty to prudently select

[457] DOL Reg. §2550.404a-5(e)(4).
[458] DOL Reg. §2550.404a-5(e)(5).
[459] Preamble to the final regulations at 75 F.R. 64922 (third column).
[460] DOL Reg. §2550.404a-5(f).

and monitor any designated investment manager or designated investment alternative offered by the plan.[461] ERISA §404(c) is discussed below.

6.04: Effect of Compliance With ERISA §404(c)

Under ERISA, a fiduciary is someone who has discretion or control over the plan's assets or administration. ERISA defines the responsibilities of fiduciaries, which include:

- undertaking actions as a fiduciary in the sole interests of the participants and beneficiaries and for the exclusive purpose of providing benefits and defraying administrative expenses;
- acting as a prudent person familiar with such matters;
- diversifying investments so as to minimize the risk of large losses to the plan; and
- complying with plan documents, to the extent that they are consistent with ERISA.[462]

One fiduciary may be responsible for bad acts of another fiduciary under certain circumstances (called "co-fiduciary liability" in ERISA). These include situations in which:

- the co-fiduciary knows of the breach by the other fiduciary, but takes no remedial action;
- the co-fiduciary facilities the breach by the other through his or her own poor performance or neglect of duties; or
- the co-fiduciary knowingly participates in or conceals the breach by the other.[463]

If one examines these definitions and obligations, it would appear that participants who direct their own investments are plan fiduciaries, because they exercise control and discretion over the assets in their accounts. Furthermore, if that were the case, the normal plan fiduciaries (such as the plan administrator and the trustee) would have co-fiduciary responsibility for the actions of the participants.

This is where ERISA §404(c) comes into play. Compliance with ERISA §404(c) is optional. If a plan complies with ERISA §404(c), two things happen:

- the participants who direct their own investments are not considered to be fiduciaries under the plan; and
- the normal plan fiduciaries have no co-fiduciary liability with regard to the investment decisions made by the participants.

Compliance with ERISA §404(c) is a defense that can be invoked by the fiduciaries if a participant sues, saying that investment losses to the participant's account are the fault of the fiduciaries because they breached their duties. The fiduciaries may claim protection under ERISA §404(c), which relieves them of such responsibility.

Failure to comply with ERISA §404(c) means that the fiduciaries cannot invoke ERISA §404(c) as a defense in a lawsuit for breach of fiduciary duties. It does not create any enhanced liability under ERISA. The participant plaintiff in the lawsuit would still need to show that the fiduciaries

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[461] DOL Reg. §2550.404c-1(d)(2)(iv).
[462] ERISA §401.
[463] ERISA §405.

breached their duties under ERISA. The fiduciaries would still be held to a prudence standard of conduct.

Part of that exercise of prudence would be compliance with the governing documents of that plan, which still might give participants the right to make investment decisions affecting their respective accounts, and the fiduciary would have a duty to follow proper directions from the participants (although now the determination of what directions are proper might have to involve assessment of the prudence of each participant's investment directions).

Also remember that, even if there is a breach of fiduciary duty, there is no recovery by the plan participants unless enforcement actions are taken, either by the DOL or by the participants. The degree of the loss involved will be a factor in determining whether to proceed with litigation, particularly from the participants' standpoint. The reason the plan failed to comply with the ERISA §404(c) requirements also may be a factor in assessing litigation risks. The litigation risk is higher if the failure goes to the heart of participant control than if the failure is a minor infraction of very technical requirements that had no bearing on the prudence of the plan's management.

Last, there is no liability on the part of the fiduciaries and no recovery to the participant-plaintiffs if there are no losses. Therefore, failure to comply with ERISA §404(c) does not, in and of itself, give a participant claim to monetary remedies. Nor does an ERISA §404(c) compliance failure in regard to one area or transaction invalidate compliance in an unrelated transaction. For example, a plan may be both an ESOP and a 401(k) plan. Participants are permitted to direct the investment of the 401(k) funds among a selection of options. However, the trustee determines the investments within the ESOP portion of the plan (which are predominantly employer securities). The ESOP portion of the plan is not subject to ERISA §404(c) protection, because the participants have no discretion in the investments. On the other hand, the 401(k) portion of the plan may comply with ERISA §404(c).

Nonetheless, compliance with ERISA §404(c) is usually advisable because it will at least insulate fiduciaries from liability for losses directly resulting from a participant's imprudent investment decisions. A plan sponsor is wise to seek the advice of legal counsel regarding the pros and cons of complying with (or attempting to comply with) the ERISA §404(c) requirements and, if it is determined that ERISA §404(c) compliance is desirable, make sure he or she understands those requirements.

6.05: Requirements for Compliance With ERISA §404(c)

There are two basic requirements that are the backbone of ERISA §404(c):

- First, a participant in a **participant-directed plan** must have an opportunity to exercise control over the investments in his or her account.
- Second, a participant must be able to select those investments from a broad range of alternatives that encompass a reasonable spectrum of risk and reward characteristics.[464]

[464] DOL Reg. §2550.404c-1(b)(1).

If the participants are not really able to control the investment of their accounts, or if the choice of investments is so narrow that the participants do not truly have the ability to control the risk and reward characteristics of their portfolios, ERISA §404(c) does not apply.

The specific requirements of ERISA §404(c) and the DOL regulations thereto are intended to ensure that these two tenets apply.

OPPORTUNITY TO EXERCISE CONTROL

Participant Control Overview

An important element of ERISA §404(c) relief is that the participant must have adequate control over his or her investment decisions. To this end, the regulations outline disclosure requirements, a need to have an identified fiduciary to accept participant investment directions and a minimum frequency with which investment changes must be available. The plan may impose charges for reasonable fees associated with investment direction.

Control may be compromised, and, thus, ERISA §404(c) relief is not available, if there is improper influence on the participant or if the participant is incompetent. In some circumstances, the fiduciary may face other liability issues, so the control requirement is not treated as violated merely because the fiduciary refuses to follow certain instructions.

The plan may use electronic media to implement its participant-direction feature. Special issues also apply in relation to brokerage account options, under which participants may invest in virtually anything offered through the broker.

Disclosure Requirements

The disclosures under DOL Reg. §§2550.404a-5 and 2550.404c-1 effective for plan years beginning on or after November 1, 2011, are required as part of the fiduciary's general fiduciary obligations under ERISA §404(a), regardless of whether the plan satisfies or attempts to satisfy the requirements for relief under ERISA §404(c)). Accordingly, the regulations under ERISA §404(c) were modified to refer to the disclosure requirements under DOL Reg. §2550.404a-5, rather than having duplicative or inconsistent disclosure rules depending on whether the plan intends to satisfy the requirements for relief under ERISA §404(c)).

Concealment of Material Information

ERISA §404(c) relief is not available if the plan fiduciary has concealed material information regarding the investment, unless disclosure of such information would violate any provision of federal law or any provision of state law that is not preempted by ERISA.[465] The thinking behind this requirement is that, without material information, it is not appropriate to consider the participant or beneficiary in control of the investment of the account.

The courts have looked at the provision of information to participants as a significant element of determining whether ERISA §404(c) should apply. For example, in In re Unisys Savings Plan

[465] DOL Reg. §2550.404c-1(c)(2)(ii).

Litigation,[466] the court stated that the extent of information provided to participants is an essential element of an ERISA §404(c) defense that participants had control over investment decisions.

Frequency of Investment Instructions

The opportunity to give investment instructions must be available with a frequency that is appropriate to the volatility of the investment.[467] This **frequency rule** applies to all investment options for which ERISA §404(c) relief is desired.

As will be discussed below, a plan that complies with ERISA §404(c) must offer certain specific investments that are called core investments, which represent the basic areas of diversification of investments. For these core investments, the opportunity to give investment instructions must be at least quarterly, even if a less frequent period would be appropriate given the investment's volatility.

The participant or beneficiary must have an opportunity to obtain written confirmation of his or her investment instructions.

Concerns surrounding compliance with this volatility requirement (as well as advancements in technology) have led many plans to move to a daily recordkeeping environment, where participants and beneficiaries can move in and out of investments at any time. If changes can be made daily with respect to an investment, the fiduciary does not have to determine whether the opportunity to give investment instructions is available on a sufficiently frequent basis.

Relief Determined on a Fund by Fund Basis

If the plan fails to satisfy the volatility requirement with respect to a particular investment option, ERISA §404(c) relief is not available with respect to that option. However, ERISA §404(c) relief may still be available with respect to the other investment options for which the frequency requirement is satisfied, so long as the other requirements of ERISA §404(c) are satisfied. This is because ERISA §404(c) relief is transactional in nature. This means that whether a fiduciary is entitled to ERISA §404(c) protection from liability is dependent on each investment decision and the specific circumstances surrounding that decision.

A failure to satisfy the requirements of ERISA §404(c) with respect to one investment or transaction does not mean that the plan fiduciary is liable for the results of all investments or transactions entered into by the participants. A plan may be partially compliant with ERISA §404(c), and the fiduciary's liability reduction is then limited appropriately to only those areas in which there is compliance.

Trading Restrictions Imposed by Mutual Funds

The fiduciary of the plan needs to address whether trading restrictions imposed by mutual funds offered under the plan are consistent with the plan's procedures pertaining to participant investments. Even if the imposition of trading restrictions is contemplated under the terms of the plan, consistent with the disclosure requirements described above, the fiduciary must make

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[466] 74 F.3d 420 (3d Cir. 1996).
[467] DOL Reg. §2550.404c-1(b)(2)(ii)(C).

sure participants are familiar with the restrictions and whether any redemption fees result from engaging in opposing transactions (i.e., buy and sell) within a certain period.

Reasonable Fees

A plan does not fail to provide an opportunity for a participant or beneficiary to exercise control over his or her account merely because the plan charges for the reasonable expenses of carrying out investment instructions, provided that procedures are established under the plan to periodically inform participants and beneficiaries of actual expenses incurred with respect to their respective accounts.[468]

Circumstances That Will Negate Control

The regulations identify circumstances that negate the participant's or beneficiary's control over the account, rendering ERISA §404(c) relief unavailable to the fiduciary. One of these circumstances is the concealment of material information. Two other circumstances are discussed below.

Improper Influence Will Negate Control

A plan fiduciary or the employer may not exercise improper influence on the participant or beneficiary.[469] If there is improper influence, the participant or beneficiary does not have effective control over investment decisions and fiduciary liability is not relieved.

Legal Incompetence of Participant Will Negate Control

If the participant or beneficiary is legally incompetent, and the fiduciary accepts instructions from that person knowing him or her to be legally incompetent, ERISA §404(c) relief is not available.[470] If the participant or beneficiary is legally incompetent, it is not appropriate under ERISA §404(c) to treat him or her as having effective control over investment decisions, thus relieving the fiduciary from ERISA liability with respect to such investment decisions.

Fiduciary May Decline to Follow Instructions Under Certain Circumstances

The fiduciary may decline to follow instructions that would:

- result in a prohibited transaction;
- cause the assets of the plan to be maintained outside of the jurisdiction of the U.S. courts;
- jeopardize the plan's tax qualification;
- be contrary to the governing plan documents;
- generate unrelated business taxable income; or
- result (or could result) in a loss exceeding the value of the account.

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[468] DOL Reg. §2550.404c-1(b)(2)(ii)(A).
[469] DOL Reg. §2550.404c-1(c)(2)(i).
[470] DOL Reg. §2550.404c-1(c)(2)(iii).

The purpose of this exception is to allow the fiduciary to refuse instructions that may result in other violations of the law without jeopardizing ERISA §404(c) relief on the basis that the participant has lost control over investment decisions.[471]

Putting a Hold on Participant's Investment Direction Authority When QDRO is Pending

The plan may want to place a hold on a participant's right to direct investments when the plan receives a qualified domestic relations order (QDRO), or possibly when the plan is notified of a pending DRO. This concern may arise when the participant's exercise of control over investments could negatively affect the value of the alternate payee's interest. In *Schoonmaker v. Amoco Corp. Employee Savings Plan,*[472] the court held that a plan may not place such a hold unless the plan's written QDRO procedures provide for it. In this case, the plan's written QDRO procedures placed the hold only when a DRO was received by the plan, not merely when the plan was notified of a pending DRO. Therefore, the plan administrator's placing a hold on the account when it heard that a divorce was pending, but prior to the receipt of the proposed DRO, was inappropriate.

The hold will compromise ERISA §404(c) relief with respect to the participant's account until the participant resumes control over his or her account (or portion of his or her account that is not awarded to an alternate payee).

Use of Electronic Media to Administer Plan's Participant-Direction Features

The IRS permits the use of electronic media to carry out administrative activities relating to participant-directed accounts, including electing investment allocations for future contributions, changing investment allocations on amounts already held in the plan, inquiring about general plan

[471] DOL Reg. §2550.404c-1(b)(2)(ii)(B).
[472] 987 F.2d 410 (7th Cir. 1993).

information (e.g., investment options) and inquiring about account information (e.g., current account balance and current investment allocations).[473]

BROAD RANGE OF INVESTMENT OPPORTUNITY

To pass responsibility for investments to the participants, there must be sufficient investment options to enable the participants to have a portfolio that covers different risk and reward characteristics.

Diversified Core Investments

There must be at least three diversified investment options (**core investments**) that offer a broad range of investment opportunity.[474] Each of the core investments must have materially different risk and return characteristics.

Because the core investment itself must be diversified, the core investment will generally need to be a **look-through investment** vehicle, such as a mutual fund, common or collective trust fund, guaranteed investment contract (GIC), bank deposit or pooled separate account maintained by an insurance company.

A plan may include other investment options, including investment options that are not inherently diversified (such as an opportunity by participants to select individual stocks). ERISA §404(c) relief is available to these other investment options, so long as the plan meets the core investment requirement described above and the other conditions of ERISA §404(c).

If You're Curious …

Brokerage Account Option

Some plans allow participants to have a separate brokerage account set up for investment-direction purposes. The brokerage account option would provide a broad range of investment options, and would certainly satisfy the frequency requirement. However, employers utilizing this approach should consider the following issues.

Disclosure Concern

The mandatory disclosures described above for plan years beginning on or after November 1, 2011, are applicable to the brokerage account option. The plan administrator must ensure that required information not provided directly by the plan is being provided by the broker. However, the self-directed brokerage option is not considered to be a designated investment option for some purposes, most particularly for the listing of investments on the comparative chart.[475]

May the Brokerage Account Be the Only Option for Directing Investments?

[473] IRS Notice 99-1, 1999-2 I.R.B., DOL Reg. §2520.104b-1(c).
[474] DOL Reg. §2550.404c-1(b)(3).
[475] Field Assistance Bulletin 2012-02, Q&A 29.

There is disagreement within the pension community whether the brokerage account option can qualify for ERISA §404(c) relief if it is the only means of directing investments. In other words, should the plan provide a menu of investment options, for which the requirements discussed above are satisfied, and from which a participant can choose specific investments in lieu of establishing a brokerage account in which the investment choices are open-ended?

Soon after the DOL finalized the regulations for participant fee disclosure, it published a series of FAQs. In these FAQs, it proposed that the plan administrator may have disclosure requirements related to investments that were commonly chosen by plan participants in their brokerage accounts.[476] The retirement and investment advisor industries protested this in strong terms, and the DOL subsequently issued an updated notice, removing the reference to any disclosure requirements related to participants' selections in their brokerage accounts.[477]

Until formal guidance is issued, the less risky approach may be to provide a menu of options in addition to the brokerage account. In other words, the brokerage account is simply one of several options on the investment menu. The participant is able to choose from among specific investment options, with respect to which the required information is supplied by the plan, or the participant can choose to establish a separate brokerage account for the purpose of directing investments. The description of investment options would include an explanation of what the brokerage account option is, and the responsibility the participant has to choose investments for that brokerage account. This is probably more in line with the requirement under the ERISA §404(c) regulations that there must be a least three core investments available which provide diversification and materially different risk and return characteristics.

Arguably, the brokerage account option itself meets the core investments requirement because the brokerage account could be invested in at least three inherently diversified options that satisfy the core investment requirement. But again, if ERISA §404(c) relief is desired, it would be safer to specify at least three specific investments that satisfy the core investment requirement, and then offer the brokerage account as another investment option.

The disclosure requirements under DOL Reg. §2550.404a-5, may be a signal that the DOL would not consider a brokerage account option that is the sole participant-directed investment option as satisfying the conditions of ERISA §404(c)(1). Because DOL guidance provides that a brokerage account or brokerage window is not a designated investment alternative for purposes of the fee disclosure regulations, it is possible that the DOL may take the same position with respect to ERISA §404(c)(1).

Administrative Concerns

If participants have separate brokerage accounts, the plan administrator is responsible for ensuring that necessary information (e.g., value of account, transactional information) is transmitted to the plan so that the plan can comply with administrative and reporting requirements. The plan administrator does not relinquish fiduciary responsibility over the participant's brokerage account. For example, the plan administrator should take steps to ensure that activity within the brokerage account will not violate the terms of the plan

[476] Id, Q&A 30.
[477] FAB 2012-02R, Q&A 39.

(e.g., unauthorized distributions from or unauthorized contributions to the account). Other considerations for the fiduciary would be specific limitations within the actual funds or fund families offered within the brokerage account (e.g., market timing guidelines that the participant may trigger resulting in the participant being banned from that specific fund or fund family due to excessive trading practices).

Nondiscrimination Testing Issues

Although making participant direction a nondiscriminatory feature in the plan is not a condition for ERISA §404(c) relief, if the plan is intended to be qualified under IRC §401(a), the employer must make sure that the nondiscrimination requirements under IRC §401(a)(4) are being satisfied. Rights and features under a qualified plan must be available on a nondiscriminatory basis.[478] The right to direct investments is an example of a right or feature that must be available on a nondiscriminatory basis.

If participants have a brokerage account option, that option also must be available on a nondiscriminatory basis. In this regard, the plan must make sure that a higher fee structure associated with a brokerage account option, or a minimum balance requirement for a brokerage account option, does not cause the option to be effectively available on a discriminatory basis.

If the brokerage account is not the only means by which the participant can direct investments (e.g., a menu of specific investment options is available instead), the fact that higher fees associated with the maintenance of a separate brokerage account are charged to the participant's account should not create a discrimination problem, so long as the fees are reasonable, although this is not certain.

Minimum balance requirements to qualify for a brokerage account option may be more problematic. When testing whether the brokerage account is available on a nondiscriminatory basis, the minimum balance must be taken into account. Thus, participants whose accounts are below the minimum balance are treated as not having the option available to them. (A minimum balance requirement is not one of those conditions listed by the regulations that may be disregarded in determining availability of a benefit, right or feature in the plan.[479]) The IRS more likely would disapprove of a minimum balance requirement if a brokerage account is the only means offered to participants to direct their own investments or if the minimum balance requirement is unreasonably high.

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[478] Treas. Reg. §1.401(a)(4)-4.
[479] Treas. Reg. §1.401(a)(4)-4(b)(2)(ii)(B).

WRITTEN TERMS OF THE ERISA §404(C) PROGRAM

In order to comply with §404(c), the terms of the participant-directed program must be set forth in the plan document or in a separate document that is incorporated by reference into the plan.[480]

If You're Curious …

Initial Choice of Investment Options

When a new plan is offering a participant-directed investment feature, or an existing plan is being amended to offer this feature for the first time, the initial choice of the investment menu is part of the plan design surrounding the plan's establishment or amendment. What, if any, fiduciary functions relate to the design of the investment menu, for which there may be potential liability under ERISA? The issue is expected to continue to be a focus of ERISA litigation.

Certainly, not every plan will choose the best investments available when the investment menu is initially designed. There are many factors that go into these choices. A plan sponsor (or other responsible person) may argue that construction of the investment menu is a plan design function, so that ERISA's fiduciary standards are not applicable.[481] Participants, however, may argue that the process by which the available investment options are chosen involves certain fiduciary activities, including the evaluation of the performance history of the investment option, how the investment option has performed in comparison to other investment options in its class, expense ratios and the overall diversification of the investment menu as a whole.

Regardless of whether the initial formulation of the investment menu is a design function or a fiduciary function (or more probably, a combination of both), there is the continuing fiduciary obligation of prudent monitoring and evaluation of the plan's investment menu.

Suits filed against First Union raised the issue of fiduciary liability with respect to investment menu design. Although a key element in the First Union litigation was that the First Union plan limited investments to First Union's own proprietary mutual funds, the litigation should concern plan sponsors in general. One of the claims was that the mutual funds available on the menu were underperforming. This could be an issue for any plan, even if the mutual fund options that are available are not connected in any way with the plan sponsor. The plaintiffs in the First Union litigation claimed that the funds had higher fees and lower returns than comparable investments. They also pointed to the fact that a human resources executive, with no investment background, was charged with the responsibility of determining the plan's investment menu.

How many plans out there could be exposed to similar charges? Probably too many. The size of the First Union settlement ($26 million) should give sponsors concern as well, and may act as an incentive for similar actions to be brought by plan participants. However, it is important to remember that merely limiting choices to the lowest-cost funds or the current best-performing funds available does not, by itself, satisfy due diligence or other

[480] DOL Reg. §2550.404c-1(b)(2)(i)(A).

[481] See, for example, Corcoran v. Bell Atlantic Corp., 22 EBC 1489 (3rd Cir. July 30, 1998), which held that the amendment of a defined benefit plan's benefit formula was not a fiduciary function because it related to plan design.

fiduciary requirements. The funds must be evaluated in their totality to determine whether they are prudent investments.

Amending the Investment Options

The governing plan documents will determine the proper procedures for modifying the investment options after they are initially selected. For example, the employer may want to modify the investment menu because certain investment options are underperforming in their asset class.

The acquisition of a company, and the merger of the seller's plan into the buyer's plan, or the assumption by the buyer of the sponsorship of the seller's plan, also may result in an amendment of the investment choices available to the participants.[482]

ERISA §404(C) RELIEF FOR INVESTMENT OPTION IN EMPLOYER SECURITIES

Only limited ERISA §404(c) relief is available for plan investments in employer securities. In particular, the DOL regulations recognize that employer securities may offer a unique situation in which the employer has reason to influence the participant to invest or divest. Furthermore, it is difficult for the securities offered by some companies to qualify as an appropriate investment under ERISA §404(c) requirements due to a reduced available market to buy or sell the securities, or a lack of applicability of the federal securities laws.

For ERISA §404(c) relief to apply, the following requirements must be satisfied:

- The security must be publicly traded on a national exchange or other generally recognized market. Investments in stock of closely held companies that are not publicly traded are not subject to ERISA
- §404(c) relief, even if the participant elects to invest portions of his or her account in such stock.
- Trading must be sufficiently frequent so that the plan may promptly execute buy or sell instructions. Investments in thinly traded securities may not be subject to ERISA §404(c) because a participant will not be able to invest in or divest out of such stock when desired.
- Participants and beneficiaries investing in the securities must receive the same information as other shareholders.
- All voting rights, tender offers and similar rights must be passed through to the participant or beneficiary.
- A fiduciary must be identified who is responsible for safeguarding the confidentiality of the investments, and who is authorized to appoint an independent fiduciary when there is the potential for undue employer influence upon participants in regard to the direct or indirect exercise of their shareholder rights under the plan.

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[482] See, for example, Franklin v. First Union Corp., 23 EBC 2817 (E.D.Va. February 17, 2000), where a court held that actions taken by the board of directors of two companies involved in a merger were sufficient to modify the investment options of the acquired company's plan.

- The independent fiduciary (that is, a fiduciary that is not affiliated with the employer) is actually appointed when there is a potential for undue employer influence to carry out the above activities.[483]

EXTENT OF ERISA §404(C) RELIEF

Relief under ERISA §404(c) is provided only to the extent the loss is the direct and necessary result of the participant's exercise of control.[484] This relief is transactional, meaning that the application of ERISA §404(c) is determined separately with respect to each investment transaction. In other words, a plan's failure to satisfy ERISA §404(c) with respect to some investment transactions does not necessarily preclude reliance on ERISA §404(c) with respect to other investment transactions for which the requirements were satisfied.

For example, a plan might not satisfy the conditions for ERISA §404(c) relief with respect to employer securities, but ERISA §404(c) might still be available for the other investment options offered by the plan. Also, ERISA §404(c) relief may not be available because of improper influence over a participant or the legal incompetence of the participant, but that does not mean ERISA §404(c) relief is lost with respect to all other participants.

On the other hand, certain failures could have a global effect and taint ERISA §404(c) relief for all transactions. For example, failure to satisfy the requirement to have at least three core inherently diversified investments would cause the entire plan to fail to satisfy ERISA §404(c).

Selection of Investment Menu and Duty to Monitor or Review Options

The fiduciary responsible for selecting the investment alternatives that are available to the participants has a duty to act prudently in constructing the investment menu that is being made available to participants, and to prudently monitor those alternatives (not a particular participant's choices). The duty to prudently review and to monitor investment selections includes the review of an investment manager who the fiduciary has selected to manage a fund to be made available to the plan participants and beneficiaries as one of the investment alternatives.[485] A fiduciary would not have a duty to monitor the performance of an investment manager that has been selected by the participant or beneficiary.[486]

Plan fiduciaries have an obligation to educate themselves about the abuses involved in the scandals that have occurred in relation to the mutual fund industry in the past (e.g., late trading, which allows an investor to buy shares at a particular day's net asset value (NAV) even though the purchase order is submitted after the day's NAV was set, ignoring the funds restrictions on trading frequency for only certain investors in the fund) to determine whether any funds currently offered by the plan were involved in such scandals, and to identify the procedures the funds offered by the plan are taking to prevent the occurrence of similar abuses. To make its analysis, the fiduciary may need to make inquiries of the mutual fund, as well as the plan's investment managers, investment advisors

[483] DOL Reg. §2550.404c-1(d)(2)(ii)(E)(4).
[484] DOL Reg. §2550.404c-1(d)(1).
[485] DOL Reg. §2550.404c-1(f)(8).
[486] DOL Reg. §2550.404c-1(f)(9).

and brokers. If a fund in the plan's investment menu is involved in investment abuses, the fiduciary must determine whether it is prudent to continue to offer the fund and, if not, the most prudent manner in which to eliminate the fund as an investment option.

Failure to Follow Plan Documents

No relief is available for following participants' investment instructions that, if implemented, would be contrary to the documents or instruments governing the plan, unless such documents or instruments are contrary to ERISA.[487] Remember, the requirement to follow plan documents is a fiduciary standard under ERISA §404(a)(1)(D). This is why the fiduciary can refuse instructions that would violate the terms of the plan if they are not in accordance with ERISA.

Must Retain U.S. Jurisdiction Over Assets

No relief is provided for a transaction that causes the fiduciary to maintain ownership of the plan assets outside the jurisdiction of the U.S. courts.[488] This is an ERISA requirement, which enables the fiduciary to refuse instructions that would cause this requirement to be violated.

Disqualification or Excess Loss

No relief is provided for a transaction that would jeopardize the qualification of the plan,[489] or that could result in a loss that exceeds the account balance.[490]

Duty to Carry Out Instructions on a Timely Basis

In *Carich v. James River Corp.*,[491] the court held that the fiduciary who is implementing the participant's investment instructions must do so within a reasonable time. In *Rex v. Lincoln Trust Co.,*[492] the court held a bank custodian liable for losses resulting from the bank's negligence in carrying out the participant's instructions.

ERISA §404(c) Can Be a Defense to a Claim of a Fiduciary's Breach

In In re Unisys Savings Plan Litigation,[493] the court found that, even if the fiduciaries acted imprudently in selecting certain Executive Life GICs for the plan's fixed income fund, ERISA §404(c) may still provide a defense. Unisys had to show that the participants' control was a cause-in-fact, as well as a substantial contributing factor in bringing about the loss incurred. The participants admitted that they alone were responsible for their investment choices, and

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[487] DOL Reg.§2550.404c-1(d)(2)(ii)(A).
[488] DOL Reg. §2550.404c-1(d)(2)(ii)(B).
[489] DOL Reg. §2550.404c-1(d)(2)(ii)(C).
[490] DOL Reg. §2550.404c-1(d)(2)(ii)(D).
[491] 958 F.2d 861 (9th Cir. 1992).
[492] 5 EBC 1138 (D.Colo. 1983.)
[493] 21 EBC 2514 (E.D.Pa. November 24, 1997).

affirmatively elected to stay with Executive Life in the face of "abundant ongoing public information" regarding the problems at the insurer.

Liability Ramifications of Failure to Comply With ERISA §404(c)

Failure to comply with ERISA §404(c) means that the fiduciaries cannot invoke ERISA §404(c) as a defense. It does not create any enhanced liability under ERISA. The fiduciaries would still be held to a prudence standard. Part of that exercise of prudence would be the governing documents of that plan, that still might give participants the right to make investment decisions affecting their respective accounts, and the fiduciary would have a duty to follow proper directions from the participants (although now the determination of what directions are proper might have to involve assessment of the prudence of each participant's investment directions).

Wrongful Promotion of Investment

In *Nelson v. IPALCO Enterprises, Inc.,*[494] the plaintiffs sought recovery with respect to investments they directed in employer stock under a plan that did not comply with ERISA §404(c). The plaintiffs' claim was, in essence, one of wrongful promotion. They alleged that the defendants violated ERISA by offering and promoting employer stock as an investment option after the company entered into a merger agreement with another company, by directing conversion of pre-merger stock to post-merger stock, and by failing to disclose to participants important information about the merger transaction. In other words, the defendants took upon themselves a fiduciary responsibility by making statements that amounted to advice about the plaintiffs' investments. The court acknowledged that this is a relatively new, developing area of ERISA case law, and there is at least a possibility of the plaintiffs prevailing. Thus, the court declined to dismiss the complaint regarding the participant-directed investments.

No Relief for Prohibited Transactions

ERISA §404(c) does not provide relief from the excise taxes that are imposed on prohibited transactions engaged in by the participant's or beneficiary's account.[495]

No Relief for Transactions With a Plan Sponsor

No relief is provided for transactions (including sales, exchanges, leases or loans) with the employer or an affiliate of the employer, because of the opportunity for undue influence.[496]

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[494] 29 EBC 2665 (S.D.N.Y. February 13, 2003).
[495] DOL Reg. §2550.404c-1(d)(3).
[496] DOL Reg. §2550.404c-1(d)(2)(ii)(E).

No ERISA §404(c) Relief for Participant Loans

No relief from fiduciary liability is granted with respect to the administration of the participant loan program.[497] Therefore, a fiduciary would retain liability with respect to the prudent administration of the plan's participant loan program, even if a participant is permitted to direct a loan to himself.

If You're Curious …

Investment Education and Advice

DOL Reg. §2509.96-1 (also referred to as Interpretive Bulletin 96-1) addresses the issue of when the provision of investment education constitutes investment advice. The regulation is in response to the concerns of employers regarding their liability with respect to investment education materials disseminated to plan participants. Although recognizing the importance of investment education in making participants better investors, many employers have not offered education programs, or offered only limited programs, due to uncertainty regarding the extent to which the provision of investment-related information may be considered to be rendering investment advice under ERISA §3(21)(A)(ii), resulting in fiduciary responsibility and potential liability in connection with participant-directed investments.

Selection of Educators and Advisors

Selecting and monitoring third-party service providers to offer investment education or investment advice are fiduciary activities. Therefore, the fiduciary is required to comply with ERISA standards of prudence. However, a plan sponsor or fiduciary would not have fiduciary responsibility or liability with respect to the actions of a third party selected by the participant or beneficiary, where the sponsor or fiduciary neither selects nor endorses the educator or advisor, nor otherwise makes arrangements with the educator or advisor to provide such services. A uniformly applied policy of providing office space or computer terminals for use by participants or beneficiaries who have independently selected a service provider to provide investment education does not constitute an endorsement by the employer of such service providers.

ERISA §404(c) Relief Not Conditioned Upon Providing Education

The provision of investment education is not a condition of ERISA §404(c) relief.[498] In addition, the provision of investment education that satisfies any of the safe harbors described in the regulation does not affect the availability of ERISA §404(c) relief. Whether the fiduciaries are entitled to ERISA §404(c) relief with respect to a participant's or beneficiary's breach depends on

[497] DOL Reg. §2550.404c-1(e)(3).
[498] DOL Reg. §2550.404c-1(c)(4).

independent factors regarding whether the plan has complied with the requirements of the law and the regulations issued by the DOL in relation to ERISA §404(c).

6.06: Default Investments

Historically, liability was not relieved by placing assets in a default investment in the absence of direction. Relief was available only where the investment is made at the participant's or beneficiary's affirmative direction. A written acknowledgment by the participant or beneficiary that assets will be invested in a default investment in the absence of contrary instructions would qualify as direction by the participant or beneficiary. For example, if a participant's enrollment form in a 401(k) plan also includes a section for selecting investments, and the form clearly states that the participant's execution of the form without providing investment instructions is treated as a direction to invest in a particular investment option, the written acknowledgment requirement should be satisfied.[499]

QUALIFIED DEFAULT INVESTMENT ALTERNATIVE (QDIA)

The DOL's failure to include default investment relief in the original ERISA §404(c) regulations raised concerns by many plan sponsors, particularly where circumstances made it less likely that an affirmative participant election would be forthcoming. For example, in a typical automatic enrollment feature in a 401(k) plan, a participant who has been automatically enrolled commonly fails to affirmatively direct the investment of the automatically enrolled contributions being made through payroll deduction, even though the plan is otherwise designed as an ERISA §404(c) plan. This made some plan sponsors reluctant to include automatic enrollment in their plans.

In response to this, as well as a reflection of Congressional intent to encourage automatic enrollment features in 401(k) plans, the Pension Protection Act of 2006 (PPA) required the DOL to issue regulations outlining the requirements for a default investment of assets in an individual account plan, under which the participant would be deemed to be exercising investment control and fiduciary liability protection similar to that of ERISA §404(c) would be available. ERISA treats a participant who has the right to direct the investment of his or her account to be in control of the account if, in the absence of an affirmative investment election, the plan invests the account in accordance with the DOL regulations.

PPA required the DOL to issue regulations providing guidance on the appropriateness of designating default investments that include a mix of asset classes consistent with capital preservation or long-term capital appreciation, or a combination of both. These provisions were effective for plan years beginning in 2007 or later. Regulations issued by the DOL reflect three specific types of investments that are deemed to meet the requirements for being default options, which the regulations call qualified default investment alternatives or QDIAs:

- ***Target date.*** An investment fund product or model portfolio that is based on a participant's age, target retirement date, or life expectancy. The funds change their asset

[499] See, the preamble to the final regulations, published in the October 13, 1992, Federal Register (57 F.R. 46906).

mix over time, to reflect the closer retirement maturity and lessening of risk tolerance. A life cycle fund or a targeted-retirement date fund would meet this requirement;[500]

- ***Demographically-averaged investment.*** An investment fund product or model portfolio that is consistent with a target level of risk appropriate for participants of the plan as a whole. A balanced fund, which provides for a reasonable mix between debt and equity securities, would meet this requirement;[501] or
- ***Investment management service.*** An investment management service arrangement with respect to which a fiduciary allocates the assets of a participant's account based on the individual's age, target retirement date or life expectancy. A managed account, under which an investment manager allocates the funds among assets of various types, including those intended for long-term appreciation and those that provide capital preservation would meet this requirement.[502]

A fourth option, the short-term preservation of principal option, is available as a safe harbor default for a limited period of time. The investment product or fund is designed to preserve principal and provide a reasonable rate of return. A money market or stable value fund will meet this requirement. The purpose of this option is to permit eligible automatic contribution arrangements (EACAs) that provide for a permissible withdrawal by new participants within 90 days of their first deferral to ensure that there is no decease in principal during that initial period. Therefore, this option may be used only for the first 120 days after the date of the participant's first deferral. After that time, the account must be moved to the normal QDIA.[503]

The fiduciary protection afforded to QDIAs is available only if the notice requirements are satisfied. Under these requirements, a participant must receive, within a reasonable period of time before each plan year, a notice explaining:

- His or her right under the plan to designate how contributions and earnings will be invested, and
- How, in the absence of any investment election, such contributions and earnings will be invested.

There must be a reasonable period of time after the notice is given and before the beginning of the plan year for an affirmative investment designation to be made. The notice must be:

- Sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and
- Written in a manner calculated to be understood by the average employee eligible to participate.[504]

FINAL REGULATIONS

Compliance with the QDIA fiduciary safe harbor is not mandatory for participant-directed defined contribution plans, not even for a plan with automatic enrollment (i.e., EACAs and QACAs).

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[500] DOL Reg. §2550.404c-5(e)(4)(i).
[501] DOL Reg. §2550.404c-5(e)(4)(ii).
[502] DOL Reg. §2550.404c-5(e)(4)(iii).
[503] DOL Reg. §§2550.404c-5(e)(4)(iv)(A) and 2550.404c-5(e)(4)(iv)(B).
[504] DOL Reg. §2550.404c-5(d).

Although including a QDIA in a participant-directed 401(k) plan is not mandatory, many fiduciaries will find compliance with the safe harbor to be desirable, particularly those dealing with automatic enrollment situations.

The DOL also intends the regulations' guidelines to encompass other situations such as:

- The failure of a participant or beneficiary to provide investment instructions following the elimination of an investment alternative or a change in service provider;
- The failure of a participant or beneficiary to provide investment instructions after affirmatively enrolling in a 401(k) plan; or
- The failure of a participant or beneficiary to provide investment instructions following a rollover.

The regulations impose six conditions for obtaining relief under ERISA §404(c), as follows:

- The default investment must be a qualified default investment alternative;
- Participants must have the right to direct investments in the account;
- Notice requirement;
- Pass through of relevant material;
- Penalty-free transfer rights; and
- Minimum investment option standards.

Qualified default investment alternative. A qualified default investment alternative (QDIA) must be an investment product or model portfolio that:

- Satisfies certain investment characteristics (target date fund, demographically-averaged fund, or investment management service);
- Does not invest in employer securities (with limited exception);
- Does not impose financial penalties on transfers from the QDIA;
- Is managed by an investment manager; and
- Is diversified so as to minimize the risk of large losses.

CHOOSING A DEFAULT INVESTMENT OPTION

If a plan is going to have a default investment option primarily for administrative certainty as to where to invest funds for which affirmative direction has not been provided, the investment should be one that would satisfy the fiduciary standards of prudence and diversification. This will minimize exposure for fiduciary liability with respect to such investments. For example, a participant could probably challenge the appropriateness of placing all investments in a money market account as a default investment, unless there is a written acknowledgment by the participant of that default investment.

The fiduciaries need to be aware of changes in circumstances under which instructions may no longer be provided (or are unable to be provided) by the participant or beneficiary. If the fiduciary knew (or should have known if he or she had acted prudently) that such instructions were no longer being provided, but failed to assume control over the investment of the account, the fiduciary risks liability if the investment allocation of the account is imprudent (or becomes imprudent due to inaction). Examples of situations that may raise such issues include:

- the death of the participant or beneficiary;

- the termination of employment of the participant, but distribution of the benefit is postponed by the participant or by the terms of the plan;
- the participant is on leave of absence (e.g., military service); or
- the participant or beneficiary becomes incapacitated.

6.07: Change in Investment Options (Mapping)

As mentioned above, when there is a change in service provider, it is common that there will also be a change in the funds offered to the participants. A period is set aside during which no participant directions are accepted, and during which the participants' funds are moved from one service provider to another. However, what investments are the funds moved into if the old investment elections are no longer valid?

Most companies use one of two methods for dealing with this problem. The first option is to liquidate all of the participants' investments and request that new investment elections be made for the new fund offerings. If a participant does not make a new investment election, the participant's benefits are placed in the default fund.

The second option, which may be more common than the first, is mapping. Mapping occurs when the plan's fiduciaries evaluate the fund options now available, and compare them to the fund options that were available prior to the change in service provider. Each "old" fund is matched to the new fund that has characteristics to which the old fund is most closely aligned—for example, a large capital equity fund at the old service provider could be matched with a large capital equity fund on the new service provider's platform. The participants' accounts are then "mapped" to the similar funds, so that their portfolios are substantially the same as they were before the change.

The historic problem with mapping has been that, under most circumstances, the resulting investment funds are not those that were specifically chosen by the participants. As a result, ERISA §404(c) was inapplicable, and the plan fiduciaries were fully responsible for the investment elections.

PPA has provided a resolution of this dilemma. Under the revised ERISA §404(c), effective January 1, 2008, fiduciary protection is extended to situations in which there is a "qualified change in investment options." In such circumstances, the participant is treated as if he or she exercised control to select the new options.[505]

A qualified change in investment options occurs when the stated characteristics of the new funds (particularly with regard to risk and return) are reasonably similar to those of the old funds. Furthermore, a notice must be provided at least 30 and not more than 60 days before the date of the change to all affected participants and beneficiaries, outlining the mapping to be done. This notice must also include:

- A comparison of the new and old funds being offered; and

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[505] ERISA §404(c)(4), as added by PPA §621(a).

- An explanation that, in the absence of affirmative investment instructions from the participant, the participant's account will be mapped as described.[506]

6.08: Blackout Periods

During any merger or transfer transaction, there usually will be a period of time when the plans involved may need to suspend investment direction activity. Such a suspension is commonly known as a **blackout period**. A blackout period often occurs as well when a plan is changing service providers, particularly if the available investment options are also going to be modified as a result of the transfer of the plan to a new service provider.

The Sarbanes-Oxley Act of 2002 instituted rules for blackout periods that occur in qualified plans. The Act defines two types of blackout periods, one during which participants are temporarily unable to change investments in a participant-directed plan, obtain distributions, or obtain participant loans. The second type of blackout period limits personal trading by certain company executives in securities of the employer if participants in a participant-directed plan in which employer securities are an option are temporarily unable to trade.

SUSPENSION OF INVESTMENT DIRECTION, DISTRIBUTIONS OR LOANS

A blackout period is defined in ERISA to be any period of more than three consecutive business days in which participants are unable to make investment elections or diversify investments, take distributions or obtain loans from the plan.[507] In general, the plan administrator is required to give participants 30 to 60 days' advance written notice of the blackout period.[508]

The **blackout notice** must contain the following items:

- The reasons for the blackout period;
- An identification of the investments and other rights affected;
- The expected dates on which the blackout period will begin and end (although these dates may be expressed as "during the week of " rather than precise dates, if the participants can access, without charge, information about the actual beginning and ending of the blackout period);
- If investments will be affected by the blackout, a statement that the participant or beneficiary should evaluate the appropriateness of their current investment decisions in light of their inability to direct investments or diversify assets credited to their accounts during the blackout period; and
- The name of and contact information for a fiduciary who can respond to participant questions about the blackout period.[509]

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[506] ERISA §404(c)(4)(C)(i).
[507] ERISA §101(i).
[508] ERISA §101(i); DOL Reg. §2510.101-3.
[509] ERISA §101(i); DOL Reg. §2510.101-3.

The DOL has issued a model blackout notice for use by plan sponsors.[510]

ERISA provides a limited exception to the blackout notice timing rules if a blackout period applies to one or more participants or beneficiaries who are entering the plan or ceasing participation solely in connection with a merger, acquisition, divestiture or similar transaction involving the plan or the plan sponsor. In this situation, the plan administrator is required only to notify the affected participants and beneficiaries as soon as reasonably practicable.[511]

If You're Curious …

These blackout rules were enacted by Congress in response to the perceived inequitable actions of Enron Corporation in imposing a blackout period while the company's stock was decreasing in value. As a result, ERISA imposes stiff penalties on plan administrators who do not provide timely notice of a blackout. The penalty is a civil penalty and a personal liability of the plan administrator; thus, penalties may not be paid with plan assets. The amount of the penalty is up to the discretion of the DOL, with a maximum penalty of $100 per day per participant, with the days at issue measured from the date on which the blackout notice should have been given through the end of the blackout period.[512]

It is important to note that the measurement period for this penalty is the same whenever the notice is late, so that being one day late could theoretically produce the same penalty as giving notice one day before the end of the blackout period. DOL representatives have informally indicated that the DOL will measure the equities of applying the maximum penalty, taking into account such considerations as the timing of the actual notice and the good faith with which the plan administrator acted.

The DOL will provide notice to the plan administrator of its intent to levy penalties, and will provide the plan administrator with an opportunity to protest this application. If the plan administrator does not respond, it is deemed to be an admission of the facts alleged by the DOL and a waiver of the plan administrator's right to appeal any penalty imposition. Therefore, a failure to timely respond to the DOL notice is tantamount to sudden death for the plan administrator, and should be avoided if at all possible.[513]

TRADING OF EMPLOYER SECURITIES DURING BLACKOUT PERIOD

The second set of blackout period rules contains limitations on trading in employer stock by insiders during a qualified plan blackout period.[514] In this context, the phrase, "blackout period,"

[510] DOL Reg. §2520.101-3(e)(2).
[511] ERISA §101(i)(3).
[512] ERISA §502(c)(7); DOL Reg. §2560.502c-7.
[513] DOL Reg. §2560.502c-7(f).
[514] Sarbanes-Oxley §306(a).

has a different meaning than the definition given for purposes of the required notice to participants.

For purposes of the limitation on trading by insiders, a blackout period is any period of more than three consecutive business days in which not fewer than 50 percent of all participants and beneficiaries under all individual account plans sponsored by the employer are temporarily prevented from buying, selling or otherwise transferring employer securities in the plan. This narrow definition means that the limitations of these rules apply only if the plan holds publicly traded employer securities and permits participants to direct the investment of their accounts into such securities.

If the Sarbanes-Oxley blackout period is invoked, the insiders may not engage in any trades relating to employer securities during the blackout period. If they do, they must disgorge any profit received to the issuing employer. The plan administrator is required to provide a notice of the blackout period, generally analogous to the blackout notice discussed above in relation to the other blackout period, to the affected participants and beneficiaries, the employer (if different than the plan administrator), the insiders and the SEC.

If You're Curious …

How these rules work in practice is still somewhat up in the air. In particular, it is not clear how the profit that must be disgorged is to be measured. There are three possible interpretations in a stock sale context:

- The profit could be considered to be the difference between the value of the stock at the beginning of the blackout period and the trade date. However, if this rule is used, insiders will suffer no penalty for trading out of stock that has decreased in value during the blackout period.
- The profit could be considered to be the difference between the value of the stock when it was purchased and the value when it was sold, even if the purchase occurred before the blackout period began. Again, however, this provides no disincentive for an executive to cut his or her losses in a depreciating stock during the blackout period.
- The profit could be measured as the difference between the price of the stock at the time sold and the price at the end of the blackout period. This possibility makes the most sense, as it would affect insiders who sold a stock that was decreasing in value during the blackout period.

It is further possible that the SEC will determine the profit to be some combination of the above concepts.

The same issues arise in a stock acquisition context. If the insider purchases an appreciating stock during the blackout period, is the profit limited to the increases experienced during the blackout period, or to all profits experienced on the stock between purchase and sale? What if the stock depreciates during the blackout period but later increases in value prior to the time it is ultimately sold by the insider?

It is important to note that the above determinations of profit are simply conjecture at this point, as no guidance has been issued.

Another issue arising in connection with the Sarbanes-Oxley blackout rules is the identification of affected securities. The Sarbanes-Oxley prohibitions apply only to securities acquired by the insider in connection with his or her service or employment as an insider. If the insider has acquired employer stock in a variety of manners—through stock options, through restricted stock grants and through personal purchases —the shares relating to employment might not be readily identifiable. It is unclear how an executive is to determine the portion of the profit to which Sarbanes-Oxley's limitations apply.

The people to whom this trading suspension applies are the company's directors or its executive officers. Although the term executive officer is not defined in Sarbanes-Oxley, most practitioners believe that the definition in analogous guidance from the SEC would apply. Rule 3b-7 to the Securities Exchange Act of 1934 defines executive officer to include:

- the president or any vice president of a public company who is in charge of a principal business unit, division or function; and any other officer who performs a policy-making function for the company.

EFFECT OF BLACKOUT PERIOD RULE VIOLATION ON ERISA §404(C) RELIEF

It is unclear whether such blackout periods automatically compromise ERISA §404(c) relief, or whether there is room in ERISA §404(c) to protect fiduciaries from liabilities during reasonable blackout periods. Ultimately, the courts will fashion the legal parameters surrounding the fiduciaries' liabilities in these situations. Fiduciaries should proceed on the basis that ERISA §404(c) may not provide protection and conduct themselves accordingly. If ERISA §404(c) does not provide a defense, the fiduciaries do not become strictly liable for investment losses, but they must be able to show that they acted prudently during the blackout period.

Blackout periods should be held to the minimum period that is practical under the circumstances. A shorter blackout period generally reduces the fiduciary risk exposure, particularly where the participants are involved in the process and provided adequate information about the pending blackout, the method that will be used to map investments, and an opportunity to reallocate investments in anticipation of the mapping process. If a blackout period stretches out for several months or longer, the responsible fiduciaries will need to decide at what point they may need to assume control over the investment of the plan assets to ensure that the ERISA standards of prudence, diversification and the exclusive benefit of the plan participants are protected.

If the participants can show losses directly attributable to an extended blackout period, the court will then look to see which fiduciaries were responsible. This was the situation in King v. National Human Resources Committee,[515] where the transferee plan did not receive the data from the transferor plan for more than six months. When the blackout period is triggered by reason of a change in service providers, the plan administrator who decides to engage the new service provider

[515] 218 F.3d 719 (24 EBC 2702) (7th Cir. 2000).

is the one primarily responsible for ensuring that the blackout period is reasonable and for taking prudent steps to monitor the activities of the old and new service providers.

6.09: Investment Procedures Under Extraordinary Circumstances

Sometimes fiduciaries will have to respond to extraordinary circumstances that may compromise some of the participants' control for a temporary period. One example would be the terrorist attacks on the United States on September 11, 2001. In News Release 01-36, the DOL recognized that fiduciaries might encounter an array of problems with respect to the investment of employee benefit plan assets upon the reopening of the securities markets following the attack. The DOL noted that such fiduciaries, in good faith, may find it necessary and prudent to take extraordinary steps in order to safeguard plan assets and to facilitate the return to orderly markets. It cautioned fiduciaries to be sensitive to ensuring that temporary procedures so adopted, and the decisions so made, are documented and adequately protect the interests of the plan participants and beneficiaries.

6.10: Review of Key Concepts

- What types of plans must provide participant disclosures under ERISA §404(a)?
- What information must be included in these participant disclosures?
- Explain the timing requirements of the participant disclosure rules.
- What is the purpose of ERISA §404(c)?
- What types of plans may use ERISA §404(c)?
- Who is a fiduciary for purposes of ERISA §404(c)?
- How does applying ERISA §404(c) protect plan fiduciaries? What is the scope of that protection?
- Name the two main requirements of ERISA §404(c).
- Identify the limited protections available for employer securities in a plan that intends to comply with ERISA §404(c).
- Under what circumstances may a fiduciary decline to follow a participant's instructions without jeopardizing ERISA §404(c)relief?
- What is a QDIA?
- What are the two types of blackout periods?
- How do blackout periods affect compliance with ERISA §404(c)?
- Describe the content and timing requirements for blackout notices.

6.11: For Practice – True or False

1. A participant in a 401(k) plan who directs the investment mix for his or her account balance in a plan that complies with ERISA §404(c) is considered a fiduciary.
2. Participant disclosures for plans intending to comply with ERISA §404(c) are different than for plans not intending to comply with ERISA §404(c).

3. Only fees that are actually incurred by the participant must be included in the annual participant disclosures.
4. The timing requirements for participant disclosures vary depending on whether they include a general explanation of fees and expenses that may be incurred versus fees and expenses that are actually incurred.
5. The investment performance data required in participant disclosures is the same for variable-return investments and fixed-return investments.
6. A plan that complies with ERISA §404(c) may have a combination of core and noncore investment options.
7. A plan that offers an intermediate-term government bond fund, a corporate bond fund and a diversified fixed income fund is considered to offer a mix of funds with materially different risk/reward characteristics.
8. A loan fund may be a core fund for purposes of ERISA §404(c).
9. ERISA §404(c) allows a plan to limit the participant's maximum investment in any one fund to 50 percent of the participant's account balance.
10. A QDIA must be diversified so as to minimize the risk of large losses.
11. A QACA must comply with the safe harbor default investment rules.

6.12: Sample Test Questions

1. Which of the following statements regarding disclosure rules for participant-directed plans is/are TRUE?

   I. SEPs are exempt from participant disclosure rules.
   II. All 403(b) plans are subject to participant disclosure rules.
   III. SIMPLE IRA plans are exempt from participant disclosure rules.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

2. Which of the following statements regarding disclosure rules for participant-directed plans under ERISA §404(a) is/are TRUE?

   I. They must be provided to a participant on or before the date on which the participant can first direct plan investments.
   II. They may be provided as part of a quarterly benefit statement as long as the disclosure timing rules are met.
   III. They may be provided as part of the plan's SPD as long as the disclosure timing rules are met.

   A. I only
   B. II only
   C. I and III only
   D. II and III only

E. I, II and III

3. Which of the following must be included in disclosures for participant-directed plans?

   I. Benchmark information for fixed-return investment alternatives
   II. Benchmark information for variable-return investment alternatives
   III. A general glossary of terms

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

4. All of the following statements regarding ERISA §404(c) are TRUE, EXCEPT:

   A. ERISA §404(c) is available to give fiduciaries liability relief for investment decisions made by participants.
   B. Fiduciaries are not responsible for selecting and monitoring the investment options available in a plan that complies with ERISA §404(c).
   C. Participants must be able to exercise control over the investments in their accounts in order for ERISA §404(c) to apply.
   D. Participants must be given a broad range of investment alternatives with differing risk/reward characteristics in order for ERISA §404(c) to apply.
   E. Fiduciaries may choose to comply with ERISA §404(c) for some parts of the plan and not others.

5. All of the following are conditions that must be met in order for an investment in employer securities to be afforded relief under ERISA §404(c), EXCEPT:

   A. The employer stock fund must be designated as a core fund.
   B. The securities must be publicly traded.
   C. The participants must receive the same information as other shareholders.
   D. Voting rights must be passed through to the participants.
   E. Trading must be available on a sufficiently frequent basis.

6. All of the following must be included in a blackout notice, EXCEPT:

   A. A list of the investments that are affected
   B. The expected dates the blackout period will begin
   C. The expected dates the blackout period will end
   D. The name and contact information of a fiduciary who can respond to participant questions about the blackout period
   E. If the blackout is due to a plan merger, a copy of the plan merger amendment

7. Which of the following is/are investments that satisfy QDIA requirements?

   I. Large-cap growth funds
   II. Small-cap value funds
   III. Balanced funds

   A. I only

B. III only
C. I and II only
D. II and III only
E. I, II and III

8. All of the following statements regarding QDIAs are TRUE, EXCEPT:

A. A life-cycle fund, which changes its asset mix over time based on a participant's life expectancy, is an acceptable default investment.
B. If QDIA requirements are met, the participant is deemed to be exercising investment control.
C. A target-date fund, which changes its asset mix over time based on a participant's target retirement age, is an acceptable default investment.
D. A plan may impose financial penalties on transfers from the QDIA if the same penalties apply to transfers from other investment options.
E. A managed account, under which an investment manager allocates the funds among assets of various types, is an acceptable default investment.

9. Based on the following information, determine the latest date on which a blackout notice is due to participants:

- The blackout is due to a transition to a new recordkeeping service provider.
- The blackout period begins on May 1, 2020.
- The plan is a participant-directed plan.

A. April 1, 2020
B. April 16, 2020
C. April 28, 2020
D. April 30, 2020
E. E. May 1, 2020

10. Which of the following are situations in which a fiduciary may decline to follow participant investment direction?

I. When following the instructions would generate unrelated business taxable income
II. When following the instructions could cause the participant's account to lose value
III. When following the instructions would result in a prohibited transaction

A. I only
B. III only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

6.13: Solutions to True or False Questions

1. False. Individuals who exercise control over the investment of plan assets are considered fiduciaries. However, ERISA provides that plan participants will not be considered fiduciaries solely because they make an election as to how they want their account balances invested.
2. False. The participant disclosures rules effective for plan years beginning on or after November 1, 2011 are required as part of the fiduciary's general fiduciary obligations under ERISA §404(a). The disclosures are the same whether the plan satisfies or attempts to satisfy the requirements for relief under ERISA §404(c) or not.
3. False. Participants and beneficiaries must be furnished an explanation of any fees and expenses that may be charged for services provided as well as information on the fees that were actually incurred.
4. True.
5. False. The required performance data required differs depending on whether the investment alternative is a variable-return investment or a fixed-return investment.
6. True.
7. False. All three of these funds are fixed income funds and do not offer a range of risk/reward characteristics.
8. False. A loan fund may not be a core fund for purposes of ERISA §404(c). A core investment must be diversified and will generally need to be a look-through investment vehicle, such as a mutual fund, common or collective trust fund, guaranteed investment contracts (GICs), bank deposits or pooled separate accounts maintained by an insurance company.
9. False. ERISA §404(c) specifically provides that a plan seeking its liability relief may not designate a maximum level of investment. The plan may, however, specify a reasonable small minimum level of investment for administrative ease.
10. True.
11. False. Although QACAs often opt to comply with the QDIA fiduciary safe harbor, it is not mandatory.

6.14: Solutions to Sample Test Questions

1. The answer is **C**. ERISA-covered, participant-directed, individual account 403(b) plans are subject to participant disclosure rules, but non-ERISA 403(b) plans are exempt.
2. The answer is **E**. All of the statements are true.
3. The answer is **D**. Benchmark information is not required for fixed-return investments.
4. The answer is **B**. Even if the plan complies with ERISA §404(c), fiduciaries are still liable for the investment choices available to participants in a plan.
5. The answer is **A**. Employer stock cannot qualify as a core fund. Because it holds only one stock, that of the employer, it does not satisfy the diversification standard.
6. The answer is **E**. A copy of a plan amendment is not a requirement of the blackout notice.
7. The answer is **B**. Large-cap growth funds and small-cap value funds do not satisfy the QDIA requirements as they each represent a single asset class. QDIAs must include a

mix of asset classes consistent with capital preservation, long-term capital appreciation or a combination of both.

8. The answer is **D**. A QDIA must allow for penalty-free transfers.
9. The answer is **A**. In general, the plan administrator is required to give participants 30 to 60 days' advance written notice of the blackout period. Thus, April 1 is the latest date in which a blackout notice is due to participants.
10. The answer is **C**. A fiduciary may not decline to follow participant investment direction simply because it could cause the participant's account to lose value. However, if the participant investment direction would result (or could result) in a loss exceeding the value of the account, the fiduciary may decline to follow such instructions.

CHAPTER 7:

ALLOCATION METHODS

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7.01: Key Terms

- Age-weighted plan
- Allocation rates
- Base compensation
- Base contribution percentage
- Combined compensation
- Cross-testing
- Design-based safe harbor
- Equivalent benefit accrual rate (EBAR)
- Excess compensation
- Excess contribution percentage
- 5 percent test
- Gateway test
- General testing
- Imputing
- Integration level
- Maximum disparity allowance
- Maximum disparity percentage
- Minimum allocation gateway
- New comparability plan
- Nondesign-based safe harbor
- Normalizing the benefit (normalization)
- One-third test
- Permitted disparity
- Rate groups
- Taxable wage base (TWB)
- Testing age
- Uniform allocation
- Uniform points plan

7.02: Introduction

One of the key tenets of qualification is that a plan must be broad-based, covering a sufficient number of rank-and-file employees, and providing them with contributions or benefits that are comparable to those of the executives. Prior chapters have discussed the coverage rules of Internal Revenue Code (IRC) §410(b), which ensure that enough NHCEs benefit to some extent. IRC §401(a)(4) makes sure that the amount of the benefits or contributions these NHCEs receive are sufficiently like those of the HCEs so that the plan is considered nondiscriminatory. In other words, IRC §410(b) measures what percentage of NHCEs benefit from the plan, while IRC §401(a)(4) evaluates how much they receive.

CONTRIBUTIONS OR BENEFITS MUST BE TESTED

A qualified plan must provide contributions or benefits that do not discriminate in favor of HCEs.[1] Because contributions or benefits (not both) must be nondiscriminatory, a qualified plan has several options for satisfying IRC §401(a) (4). A defined contribution plan usually satisfies IRC §401(a)(4) by showing contributions are nondiscriminatory, focusing on the level of employer contributions (and forfeitures) allocated to the participants' account balances. However, a defined contribution plan may show instead that benefits payable at normal retirement age from the accumulated defined contribution account are nondiscriminatory.

Similarly, a defined benefit plan usually satisfies IRC §401(a)(4) by showing that retirement benefits are nondiscriminatory, focusing on the amount of participants' retirement benefits under

[1] IRC §401(a)(4).

the plan. However, the defined benefit plan may instead show that contributions required to produce those promised benefits are nondiscriminatory.

When a defined contribution plan satisfies IRC §401(a)(4) by testing benefits, or when a defined benefit plan satisfies IRC §401(a)(4) by testing contributions, the plan is said to be cross-tested because it is testing nondiscrimination as if it were the other type of plan. If a defined contribution plan is going to be cross-tested, it must first satisfy certain gateway conditions. These conditions grant the plan permission to do nondiscrimination testing on a benefits basis. Gateway conditions are discussed in detail later in the chapter.

SAFE HARBOR AND GENERAL TESTING APPROACHES

A qualified plan is given two options for approaching IRC §401(a)(4) testing:

11. a safe harbor approach; and
12. a general testing approach.

The safe harbor approach can range from a plan design that is completely test-free to one that requires some annual testing. The general testing approach requires annual testing and focuses on the individual allocation or accrual rates of the participants. Cross-testing is a form of general testing.

SEPARATE TESTING FOR CERTAIN CONTRIBUTIONS

The testing rules outlined in the IRC §401(a)(4) regulations apply to contributions or benefits that are provided by the employer. Certain contributions are separately tested for nondiscrimination under different rules. The requirement that certain contributions must be tested separately is referred to as mandatory disaggregation.

Elective Deferrals

Elective deferrals made by the employer at the employee's election under a 401(k) arrangement must satisfy the ADP test under IRC §401(k)(3). The ADP test is the exclusive method of showing that elective deferrals are nondiscriminatory. If the 401(k) arrangement does not satisfy the ADP test, the nondiscrimination requirements cannot be satisfied through one of the other IRC §401(a)(4) testing methods discussed in this chapter, such as general testing.

After-Tax Employee Contributions

After-tax employee contributions to a defined contribution plan are required to be tested for nondiscrimination under the ACP test described in IRC §401(m). The ACP test is the exclusive method of showing that after-tax employee contributions are nondiscriminatory. If the 401(m) arrangement does not satisfy the ACP test, the nondiscrimination requirements cannot be satisfied through one of the other IRC §401(a)(4) testing methods discussed in this chapter, such as general testing.

Matching Contributions

The employer may make matching contributions (i.e., amounts that are allocated on the basis of elective contributions and/or after-tax employee contributions). Matching contributions are also

tested under the ACP test described in IRC §401(m), although under certain circumstances they may be tested under the ADP test instead.

The ACP test (and ADP test, where applicable) is the exclusive test for demonstrating that matching contributions satisfy the nondiscrimination requirement of IRC §401(a)(4). If the ACP test (or ADP test, if applicable) is not satisfied, the nondiscrimination requirements cannot be satisfied through one of the other IRC §401(a)(4) testing methods, such as general testing.

Certain matching contributions are deemed to pass the ACP test:

- matching contributions made to a SIMPLE 401(k) plan, as defined in IRC §401(k)(11); and
- matching contributions made to a safe harbor 401(k) plan, as defined in IRC §401(k)(12) or in IRC §401(k)(13), provided that the matching contribution formula satisfies the ACP safe harbor requirements of IRC §401(m)(11) or IRC §401(m)(12).

Qualified Nonelective Contributions

The employer is permitted to make contributions, known as qualified nonelective contributions (QNECs), to satisfy the ADP and ACP tests. Although QNECs may be used in the ADP test or ACP test, they also must satisfy one of the nondiscrimination tests under IRC §401(a)(4), as described in this chapter.[2]

OTHER TESTING REQUIREMENTS

The safe harbor and general testing methods address the amount of contributions or benefits provided by the employer. The IRC §401(a)(4) regulations also require that optional forms of benefit, ancillary benefits and other benefits, rights and features under the plan be made available to participants on a nondiscriminatory basis. In addition, the employer may not amend the plan in a manner that is discriminatory, nor cause discrimination because of the termination of the plan.

TESTING PERIOD IS THE PLAN YEAR

Nondiscrimination testing is performed on a plan-year basis. There is no exception for short plan years (i.e., plan years that are less than 12 months long). If a plan has a short plan year, the nondiscrimination tests must be satisfied for contributions or benefits in that short year.

DOCUMENTING THE NONDISCRIMINATION TESTING METHOD

Generally, a plan document is not required to state which nondiscrimination testing method the plan uses. Testing is an operational requirement and the plan administrator may use any method discussed in this chapter unless the plan document language limits the testing method to a given

[2] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(B)

set of options. The plan administrator may even try several different testing options before determining that the plan passes, using different testing methods from year to year.

However, if the methodology affects benefits or contributions, then the test must be stated. For example, if a defined contribution plan intends to be a design-based safe harbor plan with respect to allocating employer contributions, there are requirements that must be satisfied by the allocation formula stated in the plan document. In addition, the manner in which the plan is designed might facilitate using a certain testing method. Also, plan language addressing the ADP test is required in a plan that includes a 401(k) arrangement and plan language addressing the ACP test is required in a plan that includes matching or after-tax employee contributions.

SAFE HARBOR DEFINED CONTRIBUTION PLANS

From a plan administration standpoint, the least burdensome way to satisfy IRC §401(a)(4) is to use a safe harbor approach. A safe harbor plan can be design-based or non-design-based.

A **design-based safe harbor** means the plan is designed to satisfy IRC §401(a)(4) because of the method used to allocate employer contributions. A non-design-based safe harbor means the plan is eligible for a shortcut testing method because it is designed in a manner that is less likely to be discriminatory than more aggressive plan designs. Using a safe harbor plan design will be less costly to administer but may be more costly to the employer in terms of the level of contributions provided to its employees.

Do not confuse the safe harbor plan designs described in this section with safe harbor 401(k) plans described in IRC §§401(k)(12) and 401(k)(13). The term "safe harbor" is used throughout the IRC to describe conditions that eliminate or reduce a taxpayer's liability under the law. With regard to retirement plans, meeting "safe harbor" requirements frequently grants nondiscriminatory status to a particular plan provision, thus eliminating the need for additional testing.

DESIGN-BASED SAFE HARBOR

A design-based safe harbor plan is deemed to provide nondiscriminatory contributions because the allocation formula is designed to produce uniform allocation rates (or rates that are deemed to be uniform). This section describes the requirements for a design-based safe harbor plan and identifies

certain design options that may require some testing to show the plan satisfies the requirements of a design-based safe harbor plan.

Uniform Allocation Required

A cornerstone of the design-based safe harbor plan is that the method of allocating the employer contributions must be one that provides a uniform allocation, either as a percentage of compensation or a dollar amount.[3] The same allocation formula must apply to all employees.

Uniform Percentage of Compensation

Where uniformity is satisfied as a percentage of compensation, the plan must allocate employer contributions solely on the basis of plan year compensation, and the plan must define compensation for allocation purposes in a manner that satisfies IRC §414(s).

Definition of Plan Year Compensation

The Treasury regulations define plan year compensation to mean IRC §414(s) compensation for the entire plan year or for any specified 12-month period ending in the plan year.[4] A compensation period of less than the entire plan year may be used to determine plan year compensation if the employee is a participant for only part of the plan year (e.g., initial entry on a date other than the first day of the plan year). In that case, plan year compensation may be defined as compensation for only the portion of the plan year in which the employee is a participant.

EXAMPLE 7-1. Plan Uses IRC §414(s) Compensation for Allocation Purposes. Emma is a participant in a profit-sharing plan. The plan allocates the employer's contribution under a pro rata allocation method, based on the participant's IRC §414(s) compensation for the plan year. The plan year is a calendar year. For each plan year, Emma's IRC §414(s) compensation for the entire plan year is used to determine her allocation of employer contributions and forfeitures. The plan makes allocations using a definition of compensation that satisfies the definition of plan year compensation for safe harbor purposes.

EXAMPLE 7-2. Plan Defines Compensation for Allocation Purposes to Include Only Period of Eligibility. Cliff becomes a participant in the profit-sharing plan on July 1. The plan year ends December 31. Cliff 's IRC §414(s) compensation for the period July 1 through December 31 is used to determine his allocation of employer contributions and forfeitures for the plan year, because he was only eligible for the plan for that portion of the year. The plan uses a proper definition of plan year compensation. Alternatively, the plan may be written so

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[3] Treas. Reg. §1.401(a)(4)-2(b)(2).
[4] Treas. Reg. §1.401(a)(4)-12, Plan year compensation.

that Cliff 's compensation for the entire plan year is taken into account, even though he is a participant for only part of the year.

EXAMPLE 7-3. Noncalendar Year Uses Calendar Year Period to Measure Compensation. The plan year for a profit-sharing plan ends June 30. To allocate employer contributions as of each June 30, a participant's allocation is based on her IRC §414(s) compensation for the calendar year that ends on the preceding December 31 (e.g., compensation for the calendar year ending December 31, 2019, is used for the allocation for the plan year ending June 30, 2020). The plan uses a proper definition of plan year compensation for safe harbor purposes because it is determining compensation for a 12-month period that ends in the plan year.

If You're Curious …

Special Rule if Plan Uses Period Other than Plan Year to Measure Compensation

If a 12-month period other than the plan year is used, as in EXAMPLE 7-3, a special rule applies to new employees who are hired less than 12 months before the end of the 12-month compensation period.[5] Under this special rule, the employee's plan year compensation must be measured for the plan year or for the period of participation during that plan year.

EXAMPLE 7-4. Other than Plan Year to Measure Compensation. A plan year ends September 30, 2020, and the compensation measuring period for the plan is the calendar year ending in the plan year (2019 in this case). Drew was hired on March 1, 2019, and became a participant in the plan on April 1, 2020 (i.e., the mid-year entry date). Normally, to determine Drew's allocation, the plan would look to her compensation for calendar year 2019. Because she was hired less than 12 months before December 31, 2019 (i.e., the end of the compensation period), her plan compensation must be determined for the plan year (October 1, 2019, through September 30, 2020) or for the portion of the plan year she is a participant (April 1, 2020, through September 30, 2020). For subsequent plan years, the plan may use her compensation for the calendar year ending in the plan year to determine her plan year compensation.

Plan Designs that Provide Uniform Allocations Based on Compensation (pro rata formulas)

A plan will satisfy the uniformity requirement if the employer contribution is allocated under a pro rata formula based on plan year compensation. Under the pro rata formula, each participant's share

[5] Treas. Reg. §1.401(a)(4)-12, paragraph (5) of the plan year compensation definition.

of the employer contribution is equal to the participant's share of the total plan year compensation of all participants.

The uniformity requirement is satisfied because each participant's allocation represents the same percentage of plan year compensation. If the plan is a profit-sharing plan or stock bonus plan, where the employer's contribution is discretionary, the allocation percentage may change from year to year, but the pro rata formula will guarantee that the allocation as a percentage of compensation in a particular plan year will be the same for all participants.

The same result is achieved under a plan that has a fixed contribution, which is expressed as a uniform percentage of plan year compensation, and each participant's allocation equals the contribution so determined. A money purchase plan typically uses this design to satisfy the design-based safe harbor requirements.

EXAMPLE 7-5. Pro rata Allocation. A profit-sharing plan uses the pro rata method to allocate employer contributions. The employer contributes under a discretionary contribution formula. The plan year is the calendar year. Compensation for allocation purposes is IRC §414(s) compensation, measured for the plan year. For the plan year, there are two participants. The employer contributes $10,000 to the plan. The allocation is as follows:

Employee	IRC §414(s) Compensation	Allocation	% of IRC §414(s) Compensation
Mason	$80,000	$8,000	10%
Brad	$20,000	$2,000	10%
Total	$100,000	$10,000	10%

The total IRC §414(s) compensation of all participants is $100,000. Mason's share of that total compensation is $80,000, or 80 percent. Therefore, Mason is allocated 80 percent of the contribution, or $8,000. Brad's allocation is 20 percent. Each participant's allocation is the same percentage (10 percent) of his plan year compensation. This will always be the case under the pro rata allocation method. Therefore, the allocation method satisfies the nondiscrimination requirement by design.

EXAMPLE 7-6. Pro rata Allocation with Compensation Counted from Date of Entry. Assume, in the prior EXAMPLE 7-5, that Brad was not an eligible participant for the entire plan year, but became a participant on the July 1 entry date for the plan year, which is the mid-year entry date. The plan defines compensation for the plan year to include only compensation paid while an eligible participant. Brad's compensation for the period July 1 through December 31 is $11,000. This is his plan year compensation for allocation purposes. Therefore, the plan allocates the employer contribution by taking into account only $11,000, rather than $20,000, of Brad's compensation. The employer contribution of $10,000 is allocated on the basis of $91,000 of total compensation. Mason's share of the allocation is 80/91 and Brad's share is 11/91.

Employee	IRC §414(s) Compensation	Allocation	% of IRC §414(s) Compensation

Mason	$80,000	$8,791	10.99%
Brad	$11,000	$1,209	10.99%
Total	$91,000	$10,000	10.99%

If Brad's allocation is expressed as a percentage of his IRC §414(s) compensation for the entire plan year it would equal $1,209/$20,000, or only 6.05 percent. Because the plan limits plan year compensation to compensation paid for the period of eligibility, the percentage is based on compensation for that period to determine whether the allocation rate is uniform for safe harbor purposes. Therefore, Brad's allocation percentage is deemed to be the same as Mason's allocation percentage—10.99 percent. By taking into account only compensation for the period of eligibility, the plan has shifted part of the allocation to Mason that otherwise would have been allocated to Brad, but the plan still satisfies the design-based safe harbor.

EXAMPLE 7-7. Money Purchase Pension Plan. The contribution formula under a money purchase plan is 5 percent of plan year compensation. The allocation for each participant is the contribution determined under the contribution formula. The compensation definition satisfies IRC §414(s). The plan is a design-based safe harbor because the allocation for each participant is a uniform percentage (5 percent) of plan year compensation. This is true even if the 5 percent contribution is based on compensation only for the portion of the plan year that the employee is an eligible participant, as illustrated in **EXAMPLE 7-6**.

Permitted Disparity Formula under IRC §401(l) is Deemed to be Uniform

If a permitted disparity formula, as described in IRC §401(l), is used to allocate the employer contribution, the allocation is deemed to satisfy the uniformity requirement, even though the actual allocation percentages are greater for HCEs.[6] Permitted disparity is covered in detail later in this chapter.

Permitted disparity is not available to ESOPs.[7]

Uniform Dollar Amount

A design-based safe harbor plan may satisfy the uniformity requirement by allocating the same dollar amount to each participant (i.e., a per capita allocation). The plan also may allocate the same dollar amount per unit of service performed by the participant during the plan year, however, the unit of service may not exceed one week.[8] These types of formulas tend to favor NHCEs and so are included in the safe harbor category.

EXAMPLE 7-8. Annual Contribution Divided Equally Among Eligible Participants. A profit-sharing plan allocates an equal portion of the employer contribution to each eligible participant's account. For the plan year, there are ten

[6] Treas. Reg. §1.401(a)(4)-2(b)(2)(ii).
[7] Treas. Reg. §1.401(l)-1(a)(4)(ii).
[8] Treas. Reg. §1.401(a)(4)-2(b)(2)(i).

eligible participants, and the employer's contribution is $10,000. The allocation for each participant is $10,000/10, or $1,000. The plan is a design-based safe harbor because each participant's allocation, expressed as a dollar amount, is equal. This is not a commonly used allocation formula.

EXAMPLE 7-9. Dollar Amount Contribution per Hour of Service. A money purchase plan provides for an employer contribution equal to $2 for every hour of service credited for the plan year. Kendra is credited with 1,500 hours of service for the plan year and receives an employer allocation of $3,000. The same contribution allocation is made for all eligible participants with the same number of hours of service for the plan year. The plan is a design-based safe harbor.

EXAMPLE 7-10. Dollar Amount Contribution per Month of Service. Suppose, in the prior EXAMPLE 7-9, that the formula is $200 for each month of service credited for the plan year. The plan is not a design-based safe harbor because the unit of time used to compute the dollar amount allocation exceeds one week.

IRC §414(s) Compensation Must Be Used

The manner in which the design-based safe harbor plan defines compensation for allocation purposes will determine whether the compensation definition must be tested on an annual basis. IRC §414(s) compensation can be defined under a safe harbor definition or a modified definition.

If a safe harbor definition is used (e.g., IRC §415 compensation), then the allocation will always be a uniform percentage of IRC §414(s) compensation, and the plan can rely on the design-based safe harbor without having to test its definition of compensation. If a modified definition is used (e.g., the definition excludes bonuses, overtime and/or commissions), the compensation is not treated as IRC §414(s) compensation unless it satisfies the compensation ratio test. The compensation ratio test is outlined in Treas. Reg. §1.414(s)-1(d). Compensation definitions and the compensation ratio test are discussed in detail in The *ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics.*

EXAMPLE 7-11. Compensation is Alternative Definition under IRC §414(s). A profit-sharing plan allocates employer contributions and forfeitures under a pro rata formula based on plan compensation. Plan compensation is defined as compensation for the entire plan year (or the portion of the plan year in which the employee is a participant), taking into account all compensation for services except bonuses and commissions.

Let us assume that the plan administrator determines that the plan compensation definition satisfies the compensation ratio test for the plan year and, thus, may be treated as an IRC §414(s) compensation definition. Therefore, the plan satisfies the design-based

safe harbor because the allocation is a uniform percentage of plan compensation, and plan compensation satisfies the requirements of IRC §414(s).

Assume the allocation for the plan year equals 5 percent of plan compensation. The allocation is made to 125 eligible participants. Two of the eligible participants in the plan are Jalisa and Beverly. The following chart shows these two employees' total compensation, plan compensation, and allocation amount.

Employee	Total Compensation	Plan Compensation	Allocation	Percent of Total Compensation	Percent of Plan Year Compensation
Jalisa	$50,000	$40,000	$2,000	4%	5%
Beverly	$40,000	$40,000	$2,000	5%	5%

Jalisa has bonuses and commissions totaling $10,000, so her plan compensation is less than her actual total compensation. If each participant's allocation were expressed as a percentage of total compensation, Jalisa and Beverly's allocations would not be uniform.

However, because the plan administrator has determined that the plan's definition of compensation satisfies IRC §414(s) by passing the compensation ratio test, plan compensation may be used to determine if the allocation is uniform for nondiscrimination testing purposes. Therefore, the uniform allocation requirement is satisfied because the allocation rate is a uniform percentage of plan compensation. The percentages for Jalisa and Beverly, as well as the percentages for all other participants, are equal when expressed as a percentage of plan compensation.

The plan is a design-based safe harbor for the plan year. Note, however, that passing the IRC §414(s) test for the current plan year does not guarantee that the test will be passed in future years because compensation practices may change. The administrator will have to test the compensation definition each year to determine if the plan satisfies the safe harbor test for that year.

NONDESIGN-BASED SAFE HARBOR

There is only one type of defined contribution plan that is a non-design-based safe harbor plan: the uniform points plan.[9] This plan design requires annual testing of the contributions to show IRC §401(a)(4) is satisfied, but the testing method is simpler than the general testing method used for non-safe harbor plans. The allocation method under a uniform points plan does not satisfy the design-based safe harbor, because the allocation is determined with reference to factors other than

[9] Treas. Reg. §1.401(a)(4)-2(b)(3).

compensation. Therefore, by design, the allocations cannot satisfy the uniform allocation requirement for design-based safe harbor plans.

The non-design-based safe harbor is not available to ESOPs.[10]

Definition of a Uniform Points Plan

A **uniform points plan** uses a pro rata allocation formula, but the formula is based on a participant's points, rather than compensation. Points must be granted for service and/or age. Points also may be granted, but are not required to be granted, for units of plan year compensation. The same number of points must be granted for each year of service, each year of age and each unit of compensation.

The uniformity on the number of points granted applies only to the same type of units. The number of points granted for each year of service does not have to be the same number of points granted for each year of age or for each unit of compensation, but different numbers of points cannot be granted for different lengths of service or different age levels. For example, it is permissible to grant one point for each year of service and two points for each year of age, because service and age are different types of units. It is not permissible to grant one point for the first five years of service and two points for each year of service thereafter, because the number of points granted for each year of service is not the same.[11]

The regulation permits the plan to limit the number of years of service taken into account to a maximum number (e.g., no points assigned for years in excess of 20). If points are assigned to units of compensation, a unit of compensation must be a uniform dollar amount not exceeding $200.

Compensation

Compensation for purposes of granting points must be defined as IRC §414(s) compensation, and may be measured over any of the measuring periods discussed in relation to the design-based safe harbor plan. If the plan’s definition of compensation does not satisfy a safe harbor definition of IRC §414(s) compensation, the compensation ratio test must be satisfied for the plan to be a uniform points plan.

EXAMPLE 7-12. Points Allocation. A profit-sharing plan allocates employer contributions and forfeitures under a pro rata formula that is based on points. A participant is granted two points for each year of service and one point for each $100 of compensation. Compensation is defined under a safe harbor definition of IRC §414(s) compensation. The employer contributes $50,000 for the plan year. There are no forfeitures.

Ray’s compensation for the plan year is $30,000 and he has ten years of service. Ray is granted 300 points for compensation ($30,000 / $100 per point) and 20 points for service (two points per year times 10 years of service), for a total of 320

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[10] Treas. Reg. §1.401(a)(4)-2(b)(3)(i).
[11] Treas. Reg. §1.401(a)(4)-2(b)(3)(i)(A).

points. The points for all participants, including Ray, total 4,000. Under the pro rata formula, Ray’s share of the $50,000 contribution is based on a fraction of 320/4,000, which represents his share of the total points. Ray's allocation is 320/4,000 x $50,000, or $4,000.

Comparison of Average Allocation Rates

The non-design-based safe harbor is satisfied if the average of the allocation rates for the HCEs is not greater than the average of the allocation rates for the NHCEs.[12] Only the participants who share in the allocation are taken into account under this test. A participant's allocation rate is expressed as a percentage, determined by dividing the amount allocated by the participant's IRC §414(s) compensation. The allocation rates used for this test cannot be adjusted by imputing permitted disparity.

EXAMPLE 7-13. Testing Points Allocation Rates. Assume the same facts as in **EXAMPLE 7-12** . Ray’s allocation rate is $4,000/$30,000, or 13.33 percent. There are nine other NHCEs who participated in the allocation, with the following allocation rates: 16 percent, 14.75 percent, 11 percent, 10 percent, 8.5 percent, 6.25 percent, 5 percent, 4 percent and 3.45 percent. The average of the allocation rates of the NHCEs (including Ray) is 9.23 percent. To satisfy the non-design-based safe harbor, the average of the allocation rates of the HCEs must not exceed 9.23 percent.

If the plan fails the non-design-based safe harbor test, general testing will have to be used to show that IRC §401(a)(4) is satisfied.

ALLOCATION OF FORFEITURES UNDER SAFE HARBOR DEFINED CONTRIBUTION PLANS

A safe harbor plan, whether design-based or nondesign-based, must allocate forfeitures in the same manner as it allocates employer contributions (other than forfeitures used to pay plan expenses, as permitted under Rev. Rul. 84-156[13]). It does not matter whether the forfeitures are used to reduce the employer's contribution, or are allocated as additional employer contributions. If the plan includes matching contributions (e.g., 401(k) plan provides for a 50 percent match on elective contributions up to 6 percent of compensation), the plan may treat forfeitures (or a specified portion of forfeitures) as matching contributions. Forfeitures treated in this manner might be used to reduce the employer's matching contribution obligation, or to increase the rate of match for the plan year.

[12] Treas. Reg. §1.401(a)(4)-2(b)(3)(B).
[13] 1984-2 C.B. 97.

Any forfeitures treated as matching contributions are tested for nondiscrimination under IRC §401(m) using the ACP test, not under IRC §401(a)(4).

PLAN PROVISIONS THAT DO NOT AFFECT RELIANCE ON IRC §401(A)(4) SAFE HARBORS

A plan may contain certain provisions and still satisfy the IRC §401(a)(4) safe harbor requirements, even though the provisions might cause a participant's allocation not to be uniform or a participant's points not to be credited on a uniform basis. Any such provisions must be applied in the same way to all employees.

Entry Dates

A safe harbor plan may have multiple entry dates. If the plan contribution allocations are based on compensation only while the individual is a participant, different entry dates will cause the compensation measurement period to be different for the various new entrants. This means that the allocation will not be a uniform percentage of the plan year compensation. Nonetheless, the use of multiple entry dates does not cause the plan to fail to be a safe harbor.[14]

Conditions on Allocations

A participant's right to share in the allocation may be conditioned on employment on the last day of the plan year and/ or completion of a minimum number of hours of service (not exceeding 1,000 hours). Such conditions are commonly found in defined contribution plans. The plan may include an exception from these conditions if the participant terminates employment due to: retirement, disability, death or military service. The fact that some participants do not get an allocation because of the last-day rule or an hours-of-service rule, or the fact that an exception for retirement, disability, death or military service results in nonuniform application of these conditions, does not cause the plan to fail to be a safe harbor plan.[15]

Limits on Allocations

A participant's allocation can be limited to a specified dollar amount or percentage of plan year compensation without violating the safe harbor.[16] The limits of IRC §415 are examples of such limits, but the plan also may impose lesser limits. For example, the plan may provide that a participant's allocation cannot exceed $10,000. The allocation is still treated as uniform, even though the allocation percentage for a participant who reaches the $10,000 limit is less than the allocation percentage for participants not affected by the $10,000 limit. A safe harbor plan also

[14] Treas. Reg. §1.401(a)(4)-2(b)(4)(ii).
[15] Treas. Reg. §1.401(a)(4)-2(b)(4)(iii).
[16] Treas. Reg. §1.401(a)(4)-2(b)(4)(iv).

may limit the dollar amount of plan year compensation taken into account. IRC §401(a)(17) sets a mandatory limit on compensation, but the plan may provide for a lesser dollar limit.

Lower Allocations for HCEs

Any plan provision that results in a lower allocation for one or more HCEs does not affect the plan's status as a safe harbor plan, even though such provision does not apply uniformly to all employees.[17]

Multiple Formulas

The trickiest exception is the one for multiple formulas. This rule applies to any plan that allocates employer contributions and forfeitures under two or more formulas, including a top-heavy contribution formula. If the conditions of this rule are not satisfied, the plan is not a safe harbor and must apply the general testing.

Basic Requirements

A participant's allocation must be the greater of the allocations determined under the formulas or the sum of the allocations determined under the formulas.[18] In addition, each formula, if it were tested separately, must satisfy either the design-based safe harbor or the non-design-based safe harbor.[19]

EXAMPLE 7-14. Multiple Formulas. A profit-sharing plan allocates employer contributions and forfeitures under two separate formulas. First, an equal dollar amount is allocated among the participants, up to $500. Any amounts remaining after the initial allocation are allocated pro rata on the basis of plan year compensation. Compensation is defined under a safe harbor definition of IRC §414(s) compensation. A participant's allocation is the sum of the allocations under the two formulas. The plan is a design-based safe harbor even though it contains multiple formulas. The first formula provides a uniform dollar amount allocation and the second formula provides a uniform percentage of plan year compensation.

All formulas must be available on the same terms to all employees.[20] This means, for example, that if there is a last-day employment condition on one formula then that condition also must apply to all other formulas. Similarly, if there is an hours-of-service condition (e.g., 1,000 hours) under any formula, the same service condition must apply to all of the formulas. Formulas are not available on the same terms if one formula is for all participants, and a second formula is only for

[17] Treas. Reg. §1.401(a)(4)-2(b)(4)(v).
[18] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(A).
[19] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(C).
[20] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(1).

participants in a certain job category (e.g., salaried employees). There are, of course, some exceptions to this availability rule.

Safe Harbor 401(k) Plans

A safe harbor 401(k) plan is one that satisfies the requirements under IRC §401(k)(12) or IRC §401(k)(13). Under a safe harbor 401(k) plan, the employer sometimes makes two types of nonelective contributions: one being a safe harbor nonelective contribution, as described in IRC §401(k)(12)(C), and the other being "regular," non-safe harbor nonelective contributions. Even if the regular nonelective contributions would otherwise satisfy the design-based safe harbor requirements, the fact that the regular nonelective contribution has a last-day rule or an hours requirement and the safe harbor nonelective contribution does not result in a failure of the IRC §401(a)(4) safe harbor, as described above.

Formula Available Only to NHCEs

A formula available only to NHCEs does not violate the uniformly available rule, but only if the allocation conditions under that formula are the same as all the other formulas.[21]

EXAMPLE 7-15. Formula Available to NHCEs Only. Assume the profit-sharing plan in **EXAMPLE 7-14** makes the $500 allocation only to NHCEs, but all participants may share in the pro rata allocation based on plan year compensation. The multiple formulas do not fail to satisfy the safe harbor rule merely because one formula is available only to the NHCEs.

EXAMPLE 7-16. Formula Available to NHCEs with Special Allocation Condition. Suppose the pro rata allocation based on plan year compensation is conditioned upon employment on the last day of the plan year, but that condition does not apply to the $500 allocation. The exception to the uniform availability rule is not satisfied, and the plan cannot rely on the safe harbor rule.

Top-Heavy Formulas

If one of the formulas is a top-heavy formula, it does not fail to be uniform merely because the top-heavy allocation is available only to non-key employees (even if some of the non-key employees are HCEs), or only when the plan is top-heavy. The top-heavy formula must be available on the same terms as the other formulas. The allocation conditions relating to top-heavy contributions that are permitted under the regulations (i.e., the requirement that the participant be employed at year end in order to receive a top-heavy minimum contribution) may be applied to the top-heavy formula, without violating the same terms requirement, even though the same allocation conditions are not applied to the regular formula.[22] Remember that there is no hours

[21] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(2).

[22] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3)., Treas. Reg. §1.416-1, M-10.

requirement for a top-heavy minimum contribution; if the participant is employed at year end, he or she is entitled to the minimum contribution.[23]

For this exception to apply, the plan must be able to pass coverage under IRC §410(b) by treating an employee as not benefiting if his or her allocation is determined solely with reference to the top-heavy formula.[24] This is a troublesome requirement and is likely to result in compliance problems, particularly for smaller plans.

EXAMPLE 7-17. Plan Would Pass Ratio Percentage Test if Non-key Employees who Receive Only Top-heavy Minimum were Treated as Not Benefiting. A participant's allocation under a defined contribution plan is the greater of two amounts: the allocation determined under a pro rata formula based on plan year compensation, or the top-heavy minimum allocation.

The pro rata formula is available only to participants who are employed on the last day of the plan year and are credited with at least 1,000 hours of service. The top-heavy minimum allocation is available only to non-key participants employed on the last day of the plan year. The top-heavy formula does not apply the 1,000-hour condition because such a condition is not permitted under the Treasury regulations.

The formulas do not fail to be uniform merely because the top-heavy formula is available only to non-key participants, and the 1,000-hour requirement is applied only to the pro rata allocation formula. For the plan year, there are three HCEs and ten NHCEs. There are no excludable employees for coverage testing.

During the plan year, two of the NHCEs fail to complete at least 1,000 hours of service. Both of these NHCEs are non-key employees and receive the 3 percent top-heavy minimum contribution. The other participants receive an allocation under the pro rata formula equal to 8.5 percent of plan year compensation.

	1,000+ Hours	Less than 1,000 Hours	Regular Contribution	Top-Heavy Contribution	Total
HCEs	3	0	3	0	3
NHCEs	8	2	8	2	10

If the two NHCEs who received only the top-heavy contribution were treated as not benefiting, the plan would pass coverage because 80 percent of the NHCEs (8/10) would be benefiting for coverage purposes. Therefore, the plan does not fail to be a safe harbor plan merely because of the separate top-heavy formula.

EXAMPLE 7-18. Plan Would Fail Ratio Percentage Test if Non-key Employees who Receive Only Top-heavy Minimum were Treated as Not Benefiting. Assume, in **EXAMPLE 7-17**, that four NHCEs (rather than only two NHCEs) fail to complete at least 1,000 hours of service and receive only the top-

[23] Treas. Reg. §1.416-1, M-10.
[24] Treas. Reg. §1.401(a)(4)-2(b)(4)(vi)(D)(3).

heavy allocation. Although these participants are actually benefiting for coverage purposes, the plan must be able to pass coverage without them to satisfy the safe harbor rule under IRC §401(a)(4).

If the four NHCEs were treated as not benefiting, only 60 percent of the NHCEs would be benefiting for the plan year. Because 100 percent of the HCEs are benefiting, the plan would fail to satisfy the ratio percentage test because the plan ratio percentage is less than 70 percent (60 percent NHCE ratio / 100 percent HCE ratio = 60% plan ratio percentage). Therefore, the ratio percentage test would be failed.

Unless the plan can pass the average benefit test (by assuming the four NHCEs who received only the top-heavy contribution have a zero percent allocation), the plan will not satisfy this exception for multiple formulas. In that case, the plan may not rely on the safe harbor test under IRC §401(a)(4), and the plan will have to be tested under the general testing method.

Actual Coverage Testing is Not Affected under Top-heavy Plan Exception

Remember that the rule described above is applied solely for purposes of determining whether the existence of the separate top-heavy allocation formula causes the plan to fail to be a safe harbor plan under IRC §401(a)(4). In other words, this rule relates only to nondiscrimination testing.

For actual coverage testing under IRC §410(b), an employee is treated as benefiting, even if his or her only allocation is due to the application of the top-heavy rules. Remember that IRC §410(b) coverage testing measures the percentage of NHCEs that benefit from the plan, regardless of the amounts that they receive, while IRC §401(a)(4) evaluates the actual amounts that were received.

Related Employers Maintaining a Single Plan With Separate Contribution/Allocation Formulas

If a plan is maintained by more than one related employer [i.e., a controlled group of businesses under IRC §414(b) or (c), or an affiliated service group under IRC §414(m)], the plan might provide for separate contribution and/or allocation formulas for the participants employed by each participating employer. Such a plan would fail to be a safe harbor plan because the multiple formulas do not apply uniformly to all participants.

EXAMPLE 7-19. Separate Formulas for Separate Employee Groups. Corporation X and Corporation Y constitute a controlled group of corporations, as described in IRC §414(b). Corporation X and Corporation Y jointly maintain a defined contribution plan. The employees of Corporation X receive a uniform allocation of 8 percent of plan year compensation, but the employees of Corporation Y receive a uniform allocation of 5 percent of plan year compensation. The plan is not a safe harbor because there are two allocation formulas, and they are not available uniformly to all employees.

7.03: Permitted Disparity

Permitted disparity is the term used in IRC §401(l) for considering the employer's contribution to Social Security on behalf of a plan participant in determining whether the contributions or benefits under a qualified plan are nondiscriminatory. Both the employer and the employee make annual contributions to Social Security (FICA contributions) for retirement, disability, death and health (Medicare) benefits. The portion of the employer’s contribution relating to retirement [called old age, survivor and disability income benefits (OASDI) under the Social Security system] is similar to the type of benefits the employer provides through the qualified plan. However, the contributions are made only on compensation up to a certain level [called the Social Security taxable wage base (TWB)]. Therefore, the employer’s contributions, as well as the Social Security benefits received, are a higher percentage of compensation for the lower-paid employees than they are for the employees who earn in excess of the TWB.

Permitted disparity is a means of weighting the contribution in favor of people who earn in excess of the TWB so that their entire retirement benefit—from both the employer and Social Security—is uniform for all employees as a percentage of compensation. Permitted disparity may be used for nondiscrimination testing purposes in two different ways: by plan design (i.e., the safe harbor method) or by imputing (i.e., adjusting allocation or benefit rates under the general testing method prescribed by the IRC §401(a)(4) regulations).

SAFE HARBOR IRC §401(L) PLANS

A safe harbor permitted disparity plan is operated in accordance with the design-based safe harbor requirements under the IRC §401(a)(4) regulations and incorporates the rules of IRC §401(l) into the allocation formula. If the plan fails to satisfy IRC §401(l), either by design or because of variables inherent in the plan terms (e.g., a non-safe harbor compensation definition used to determine allocations or benefits), the plan is not necessarily disqualified. Such failure simply means the plan is not an IRC §401(l) safe harbor plan, and must use general testing under the IRC §401(a)(4) regulations to show that the plan is nondiscriminatory.

Design-Based Safe Harbor

To satisfy the IRC §401(l) safe harbor, a defined contribution plan must satisfy all the requirements of a design-based safe harbor.[25] One of the conditions of a design-based safe harbor is that the allocation formula under the plan is designed to produce allocations that are a uniform percentage of plan year compensation or a uniform dollar amount. When the IRC §401(l) safe harbor is used, the allocations are deemed to be a uniform percentage of plan year compensation, even though they are not actually uniform. The disparity in the allocation rates created by the IRC §401(l)

[25] Treas. Reg. §1.401(a)(4)-2(b).

allocation formula is permitted because the disparity is derived from the employer's contributions to Social Security on behalf of the participants.

Definition of Compensation Used for Allocation with Permitted Disparity

For the IRC §401(l) safe harbor to be satisfied, the compensation used in the allocation formula must meet the requirements of IRC §414(s) – that is, the compensation definition must be nondiscriminatory. The plan's definition of compensation may be a safe harbor definition of IRC §414(s) compensation or it may be an alternative definition that satisfies the compensation ratio test. If an alternative definition is used, it is possible that, because of a change in demographics or compensation practices, the plan's definition will not satisfy IRC §414(s) for a particular plan year. In that case, the plan would not be an IRC §401(l) safe harbor plan for that plan year (unless timely corrective action is taken), and the general nondiscrimination testing rules of IRC §401(a)(4) will apply.

Plan year compensation must be limited to the dollar limit in effect under IRC §401(a)(17) ($285,000 for 2020).

Allocation Based Partly on Excess Compensation

The IRC §401(l) safe harbor allows the plan to make allocations on the basis of excess compensation. Excess compensation is the amount by which a participant’s plan year compensation exceeds the integration level stated in the plan.

Integration Level

The **integration level** may be the TWB or any specified amount less than the TWB.[26] The **taxable wage base** (TWB) is the maximum amount of wages that are considered for Social Security purposes. The TWB may be adjusted each calendar year. The TWB for 2020 is $137,700 and for 2019 is $132,900.

If the plan year is not a calendar year, the TWB in effect at the beginning of the plan year is used. For example, the TWB for a plan year beginning July 1, 2019, and ending June 30, 2020, is the TWB in effect for 2019 ($132,900), not the TWB in effect for 2020 ($137,700).

Single dollar amount. The integration level may be stated as a single dollar amount that applies in all plan years, so long as the dollar amount does not exceed the current TWB.[27] For example, the integration level may be stated as $30,000. Under this approach, the administrator need not adjust the integration level each year merely because the TWB has changed.

Floating integration level. The integration level may be defined by formula, as a percentage of the current TWB (e.g., 85 percent of the TWB). This approach is known as floating the integration level, because the integration level changes when the TWB changes. If desired, the formula may

[26] Treas. Reg. §1.401(l)-2(d).
[27] Treas. Reg. §1.401(l)-2(d)(3).

include a rounding procedure. For example, the integration level could be defined as 80 percent of the TWB increased to the next $100 level, to ensure the integration level is a multiple of $100.

Prorating the Integration Level for Short Periods

If the plan year is a period of less than 12 months (e.g., following the amendment of the plan year), and plan year compensation is limited to that short period, the integration level must be prorated.[28] The proration is accomplished by multiplying the integration level by an adjustment fraction. The numerator of the fraction is the number of months in the short plan year, and the denominator is 12.

EXAMPLE 7-20. Short Plan Year. A plan's plan year is amended from a period ending June 30 to the calendar year, effective January 1, 2020. A short plan year from July 1, 2019, through December 31, 2019, is created by the amendment. The allocation of employer contributions for the short plan year is based solely on compensation for that six-month period. The integration level is the TWB. For the short plan year, the TWB for 2019 ($132,900) must be multiplied by 6/12, or ½, because there are only six months in that plan year. The integration level for this short plan year is $66,4500.

No proration for short period of participation in a 12-month plan year. The IRC §401(l) safe harbor is based on plan year compensation. One option for defining plan year compensation is to limit compensation to the portion of the plan year in which an employee is a participant. For example, an employee might become a participant on July 1 under a calendar year plan. The employee's plan year compensation may be limited to compensation from July 1 to December 31. Because the plan year is actually 12 months long, the integration level is not prorated, even though the plan year compensation for the mid-year entrant is measured over only six months. The proration rule applies only when the plan year comprises fewer than 12 months and the compensation period used to determine allocations for that short plan year is also less than 12 months.

If You're Curious …

New plan with initial short year. Presumably, this proration requirement would apply to a new plan that has a short period for its first plan year, although the regulations do not address this situation specifically. For example, suppose a company adopts a profit-sharing plan with a permitted disparity formula. The effective date of the plan is July 1, but the plan year ends December 31, so the first plan year runs for six months from July 1 to December 31. If allocations are performed on the basis of compensation for the plan year, and compensation is measured only for that short period, then the integration level is prorated to one-half to reflect the six-month plan year. If use of the full integration level is desired, one of the following two approaches should be taken: (1) define compensation for the first plan year as the 12-month period ending on the last day of that

[28] Treas. Reg. §1.401(l)-2(d)(5).

plan year, or (2) adopt the plan with an effective date of January 1 rather than July 1, so that the first plan year is 12 months long.

Plan year in which plan terminates. The termination of a plan does not, by itself, result in the shortening of a plan year. If, for the plan year in which the plan terminates, an employer contribution is allocated under a permitted disparity formula, a proration of the integration level would not be necessary. However, it is unclear whether proration is required if only compensation through the date of termination is used for the allocation. There are arguments on both sides of the controversy. The most conservative approach would be to prorate if only a partial year's compensation is used for all employees. However, the best alternative is to outline the final allocation method as part of the plan termination amendment (if one is prepared), so that there is no doubt of the employer's intent or the required plan terms.

Determining the Maximum Disparity Allowance

The **maximum disparity allowance** is the maximum percentage difference between allocations on compensation above the TWB and allocations on compensation that is less than the TWB that can be provided without violating the IRC §401(l) safe harbor. The allocation may result in a disparity that is less than the maximum, so long as the disparity is uniform for all participants. To satisfy the IRC §401(l) safe harbor, the disparity resulting from the formula cannot exceed the maximum disparity allowance.

Disparity Provided by the Formula

The disparity provided by the plan's allocation formula is the difference between the excess contribution percentage and the base contribution percentage.

Excess contribution percentage. The **excess contribution percentage** is the portion of the contribution (expressed as a percentage) that is allocated on **excess compensation** (i.e., compensation in excess of the integration level).

Base contribution percentage. The **base contribution percentage** is the portion of the contribution (expressed as a percentage) that is allocated on base compensation. **Base compensation** means plan year compensation up to the integration level.

Maximum Disparity Allowance

The maximum disparity allowance is the lesser of a maximum disparity percentage or the base contribution percentage.

Maximum disparity percentage. The **maximum disparity percentage** depends on the integration level, and how it compares to the TWB in effect at the beginning of the plan year.[29] For example,

[29] Treas. Reg. §1.401(l)-2(d).

the maximum disparity for a plan year that begins in 2019 depends on how the integration level compares to the 2019 TWB (i.e., $132,900).

The maximum disparity percentage is determined under the following table.

Integration level	Maximum disparity percentage
TWB	5.7%
More than 80%, but less than 100%, of TWB	5.4%
More than 20%, but not more than 80%, of TWB	4.3%
20% or less of TWB	5.7%

If the integration level is expressed as a dollar amount (e.g., $30,000), the dollar amount must be compared to each year's TWB to see which maximum disparity percentage applies. Notwithstanding the above table, where the base contribution percentage is less than 4.3 percent, the maximum disparity allowance is equal to the base contribution percentage, regardless of the integration level.

EXAMPLE 7-21. Integration Level is the TWB. The integration level under a plan is the TWB. The base contribution percentage under the allocation for the plan year is 10 percent. The maximum disparity percentage is 5.7 percent, because the integration level equals the TWB. The IRC §401(l) safe harbor is satisfied if the disparity for the plan year does not exceed 5.7 percent (i.e., the lesser of the base contribution percentage or the maximum disparity percentage). Therefore, the allocation on compensation in excess of the TWB cannot exceed the base percentage (10 percent) plus the maximum disparity percentage (5.7 percent), or 15.7 percent.

EXAMPLE 7-22. Base Contribution Percentage is Less than the Maximum Disparity Percentage. Suppose, in **EXAMPLE 7-21** that the base contribution percentage for the plan year is 3 percent, rather than 10 percent. Because that percentage is less than the maximum disparity percentage of 5.7 percent, the maximum disparity allowance for the plan year is 3 percent. The plan does not satisfy the IRC §401(l) safe harbor unless the disparity under the allocation is 3 percent or less. In this case, the allocation on compensation in excess of the TWB cannot exceed twice the base percentage, or 6 percent.

EXAMPLE 7-23. Integration Level is a Percentage of the TWB. The integration level under a plan is 80 percent of the TWB increased to the next $1,000 level. This formula will always result in an integration level that is more than 80 percent of the TWB, but less than the TWB. Therefore, the maximum disparity allowance is 5.4 percent. If the base contribution percentage for the plan year is 5.4 percent or greater, the IRC §401(l) safe harbor is satisfied if the

disparity does not exceed 5.4 percent. If the base contribution percentage is less than 5.4 percent, the IRC §401(l) safe harbor is satisfied if the disparity does not exceed the base contribution percentage.

EXAMPLE 7-24. Integration Level is a Specified Dollar Amount. The integration level under a plan is $60,000. For the 2019 plan year (i.e., the plan year that begins in 2019), the integration level is divided by $132,900 (i.e., the TWB for 2019) to determine the maximum disparity percentage.

The fraction $60,000/$132,900 equals 45.15 percent, so the maximum disparity percentage is 4.3 percent.

If the base contribution percentage for the plan year is 4.3 percent or greater, the IRC §401(l) safe harbor is satisfied only if the disparity does not exceed 4.3 percent. If the base contribution percentage is less than 4.3 percent, the IRC §401(l) safe harbor is satisfied only if the disparity does not exceed the base contribution percentage.

Maximum Disparity Allowance Applies to All Defined Contribution Plans

The maximum disparity allowance may not be exceeded with respect to all defined contribution plans maintained by the employer in which the employee participates. For example, if the employer maintains a profit-sharing plan and money purchase plan, and the money purchase plan utilizes 5.7 percent maximum disparity for a plan year, no permitted disparity can be used in the profit-sharing plan for the same participant.

Why Permitted Disparity Is Considered Nondiscriminatory

Permitted disparity is considered a safe harbor for nondiscrimination purposes because it takes into account that the Social Security system disfavors higher-paid employees.

Permitted Disparity under Qualified Plan Evens the Score

As discussed earlier, the OASDI component of the employer's contributions to Social Security (i.e., FICA taxes) is based only on compensation up to the TWB. The permitted disparity rules treat the OASDI portion as if it were made under the qualified plan. The OASDI portion is deemed to be 5.7 percent. By permitting a disparity up to 5.7 percent under the qualified plan allocation, IRC §401(l) allows the qualified plan allocation to even the score between employees who earn more than the TWB and employees who earn less than the TWB.

EXAMPLE 7-25. Permitted Disparity Formula. To illustrate the nondiscriminatory effect of permitted disparity, assume the following allocation for a plan year beginning 2018: 10 percent of plan year compensation plus 5.7 percent of excess compensation. The integration level is the TWB ($128,400 for the 2018 plan year), so excess compensation is the employee's compensation in excess of the TWB.

Assume the plan has one HCE, with plan year compensation of $228,400, and one NHCE, with plan year compensation of $40,000. For the 2018 plan year, the HCE's excess compensation is $100,000 ($228,400 plan year compensation less the $128,400 TWB being used as the integration level). The NHCE's excess compensation is $0. The allocation for each employee would be as follows:

Employee	10% of Compensation	5.7% of Excess Compensation	Total Allocation	Percentage of Compensation
HCE	$22,840	$5,700	$28,540	12.49%
NHCE	$4,000	$0	$4,000	10.00%

Comparing the allocations as a percentage of plan year compensation appears to discriminate in favor of the HCE. However, let us compare the allocations if we take into account the OASDI portion of the contribution made by the employer on each employee's behalf. That contribution is deemed to be 5.7 percent of each employee's base compensation (i.e., plan year compensation up to the TWB). The HCE's base compensation is $128,400, so the employer's OASDI contribution is 5.7% x $128,400, or $7,319. The NHCE's base compensation is $40,000, so the OASDI contribution is 5.7 percent x $40,000, or $2,280. If we take into account the deemed value of the employer's OASDI contribution on behalf of each employee, the following allocation results:

Employee	Plan Allocation	OASDI Contribution	Combined Plan + OASDI	Percentage of Compensation
HCE	$28,567	$7,319	$35,886	15.7%
NHCE	$4,000	$2,280	$6,280	15.7%

By taking into account the employer's OASDI contribution, the total allocation of employer contributions is equalized as a percentage of plan year compensation.

Rough Justice in Some Cases

EXAMPLE 7-25 above illustrates pure integration with Social Security, where the integration level used by the plan is the TWB, and the disparity percentage is 5.7 percent. If the integration level is less than the TWB, the results will not be equal. For this reason, the maximum disparity percentage is lowered to 5.4 percent or 4.3 percent for certain integration levels. This provides rough justice without unduly complicating the permitted disparity rules. Also, if the base contribution percentage is less than the maximum disparity percentage, the disparity in the qualified plan is limited to the base contribution percentage. This limitation is not based on Social Security integration, but ensures that employees who earn less than the integration level will receive a minimum allocation rate under the qualified plan.

If You're Curious …

Sample Profit-Sharing Plan Formulas

A profit-sharing plan may provide a fixed contribution formula and incorporate IRC §401(l) into that fixed formula. However, profit-sharing plans typically provide a discretionary contribution formula, so the employer is not obligated to contribute a

certain amount each year. When a profit-sharing plan provides for a discretionary contribution, it must have a definite formula under which the contribution is allocated. How does a formula allocate a discretionary contribution so that the result satisfies IRC §401(l)?

Two-step Formula

Many profit-sharing plans use a two-step formula to comply with IRC §401(l). The first part of the formula incorporates permitted disparity. The formula is merely a variation of the pro rata allocation method, where the contribution is allocated relative to plan year compensation. Under the permitted disparity formula, the contribution is allocated proportionate to the sum of the plan year compensation and the excess compensation (referred to as **combined compensation**). The maximum allocation made on combined compensation is capped at the maximum disparity percentage (5.7 percent, 5.4 percent or 4.3 percent, whichever is applicable). If any contribution remains unallocated after the first part of the formula, the remainder is allocated under the normal pro rata method, based on plan year compensation.

Examples illustrating the two-step formula. To simplify the illustration, assume only two participants in each example, one earning $170,000 and the other earning $30,000. The integration level is the TWB. The 2018 TWB of $128,400 is used in the examples.

EXAMPLE 7-26. Employer Contribution Large Enough to Use Maximum Permitted Disparity. The employer makes a $48,000 contribution for the plan year. Because the integration level is the TWB, 5.7 percent is the maximum permitted disparity.

Therefore, the maximum amount that can be allocated under the step one allocation is 5.7% x $241,600, or $13,771. $241,600 is the total of the combined compensation – the total of $30,000 for the NHCE and $170,000 plus $170,000 - $128,400 for the HCE ($30,000 + $170,000 + $41,600 = $241,300).

Because the contribution to be allocated exceeds $13,771, the step one allocation for each participant can be determined by simply multiplying that participant's combined compensation by 5.7 percent. For the HCE, that amount is 5.7% x $211,600, or $12,061. For the NHCE, that amount is 5.7% x $30,000, or $1,710.

The remainder of the contribution is allocated under step two, proportionate to plan year compensation. For the HCE, that amount is $170,000 of plan year compensation divided by $200,000 total plan year compensation times the $48,000 total contribution less the $13,771 that was already allocated under step one [($170,000/$200,000) x $34,229 = $29,095].

For the NHCE, that amount is $30,000 of plan year compensation divided by $200,000 total plan year compensation times the $48,000 total contribution less the $13,771 that was already allocated [($30,000/$200,000) x $34,229 = $5,134].

Employee	Plan Year Comp.	Excess Comp.	Combined Comp.	Step One Allocation	Step Two Allocation	Total Allocation
HCE	$170,000	$41,600	$211,600	$12,061	$29,095	$41,156
NHCE	$30,000	$0	$30,000	$1,710	$5,134	$6,844
Total	$200,000	$41,600	$241,600	$13,771	$34,429	$48,000

As the TWB increases, the relative disparity amount in favor of the HCE decreases.

If forfeitures were allocated, they would increase the step two allocation, because the step one allocation is limited to 5.7 percent of combined compensation.

If the integration level is less than the TWB, the maximum percentage of combined compensation in step one might be 5.4 percent or 4.3 percent, as required by the maximum disparity rules. The lesser integration level will also change the excess compensation amount in the third column of the table and the combined compensation amount in the fourth column of the table.

EXAMPLE 7-27. Employer Contribution Not Enough to go Beyond Step One Allocation. If the amount of contributions and forfeitures to be allocated is less than 5.7 percent of total combined compensation of the participants, then the entire amount will be allocated solely under step one.

In the prior **EXAMPLE 7-26**, if the contributions and forfeitures to be allocated total less than $13,771, the entire allocation will be completed under step one. This will result in utilization of less than the 5.7 percent maximum disparity.

If the amount to be allocated is $12,000, instead of $48,000 as shown in the prior **EXAMPLE 7-26**, the following allocation would result.

Employee	Plan Year Comp.	Excess Comp.	Combined Comp.	Step One Allocation	Step Two Allocation	Total Allocation
HCE	$170,000	$41,600	$211,600	$10,510	$0	$10,510
NHCE	$30,000	$0	$30,000	$1,490	$0	$1,490
Total	$200,000	$41,600	$241,600	$12,000	$0	$12,000

Each participant's step one allocation is a proportionate share of the contribution, based on combined compensation. For the HCE, the allocation is determined as follows: $211,600/$241,600 x $12,000. For the NHCE, the allocation is determined as follows: $30,000/$241,600 x $12,000.

In this example, the step one allocation represents approximately 4.97 percent of combined compensation. This means the allocation for each participant equals 4.97 percent of plan year compensation, plus 4.97 percent of excess compensation. Although the maximum disparity percentage (5.7 percent) is not reached, the allocation produces the greatest possible disparity (4.77 percent) allowed with the amount of employer contributions to be allocated. Using combined compensation to allocate the contribution ensures the disparity percentage will equal the base contribution percentage until the maximum disparity percentage is reached under step one.

The compensation dollar limit under IRC §401(a)(17) is applied to the plan year compensation, not to the combined compensation. The combined compensation is simply a shortcut mathematical tool for allocating simultaneously on the basis of plan year compensation and excess compensation. The parts that make up combined compensation – plan year compensation and excess compensation— are each determined with reference to the compensation dollar limit.

EXAMPLE 7-28. Limiting Compensation to IRC §401(a)(17). If a participant's compensation is $210,000, excess compensation for the 2018 plan year is $210,000 minus $128,400, or $81,600. The combined compensation is $291,600, which is not limited to $275,000 [i.e., the IRC §401(a) (17) compensation dollar limit in effect for plan years beginning in 2018].

The combined compensation includes excess compensation twice because permitted disparity allows the plan to allocate up to 5.7 percent of excess compensation in addition to 5.7 percent of plan year compensation (which includes excess compensation). An allocation to the HCE of 5.7% x $210,000 of plan year compensation ($11,970), plus 5.7% x $81,600 of excess compensation ($4,651), which totals $16,621, is mathematically the same as 5.7% x $291,600 (combined compensation), which also equals $16,621.

Three-step Formula

Some permitted disparity allocation formulas are stated as a three-step formula. The three-step formula simply separates the first step of the two-step formula into two separate calculations—one on plan year compensation and the other on excess compensation—rather than allocating on the basis of combined compensation.

The first step of the three-step formula allocates on the basis of plan year compensation, to establish the base contribution percentage. The second step of the three-step formula allocates on the basis of excess compensation until maximum disparity is reached.

One drawback to the three-step formula, when compared to the two-step formula, is that, unless the contributions and forfeitures to be allocated are sufficient to carry over into step two, there is no permitted disparity utilized for the plan year. The two-step formula always utilizes at least some permitted disparity because the first step is based on combined compensation.

Examples illustrating the three-step formula. The following examples are the same as those used to illustrate the two-step formula, so the two formulas can be compared.

EXAMPLE 7-29. Employer Contribution Large Enough to Use Maximum Disparity. This example uses the same information as in **EXAMPLE 7-26**.

Employee	Plan Year Comp.	Excess Comp.	Step One Allocation	Step Two Allocation	Step Three Allocation	Total Allocation
HCE	$170,000	$41,600	$9,690	$2,371	$29,095	$41,156

NHCE	$30,000	$0	$1,710	$0	$5,134	$6,844
Total	$200,000	$41,600	$11,400	$2,371	$34,229	$48,000

In this example, the contribution is 24 percent of total participant compensation, just like in **EXAMPLE 7-26** under the two-step formula. The step one allocation is limited to 5.7 percent of plan year compensation. The 5.7 percent limitation reflects the maximum disparity permitted when the integration level is the TWB.

The step two allocation incorporates maximum disparity by allocating 5.7 percent of excess compensation. If the allocation under steps one and two are added together, the result is the same as the step one allocation under the two-step formula.

The step three allocation, like the step two allocation under the two-step formula, is determined solely on the basis of plan year compensation, under a standard pro rata allocation method.

Because the total amount being allocated in this example is the same as the example under the two-step formula, and the allocation advances to step three, the allocation result is identical to the result in the two-step formula. In other words, if the total amount being contributed would include an allocation under step three, then the three-step and two-step formulas produce the same allocation result, because at that point, the maximum disparity is achieved and the allocation in the last step is simply a pro rata allocation based on total compensation.

EXAMPLE 7-30. Employer Contribution Not Enough to go Beyond Step Two Allocation. This example uses the same facts as in **EXAMPLE 7-26**. If the amount of contributions and forfeitures to be allocated does not equal 5.7 percent of plan year compensation plus 5.7 percent of excess compensation, then the entire amount will be allocated solely under steps one and two.

In the prior **EXAMPLE 7-29**, if the contributions and forfeitures to be allocated total less than $13,771 (the sum of the maximum allocation under steps one and two), the entire allocation will be completed under the first two steps. This will result in utilization of less than the 5.7 percent maximum disparity.

If the amount to be allocated is only $12,000, instead of $48,000 as shown in the prior **EXAMPLE 7-26**, the allocation will be completed under the first two steps and the following allocation would result.

Employee	Plan Year Comp.	Excess Comp.	Step One Allocation	Step Two Allocation	Step Three Allocation	Total Allocation
HCE	$170,000	$41,600	$9,690	$2,371	$29,095	$41,156
NHCE	$30,000	$0	$1,710	$0	$5,134	$6,844
Total	$200,000	$41,600	$11,400	$2,371	$34,229	$48,000

The step one allocation is limited to 5.7 percent of plan year compensation. After applying step one, $600 remains for allocation under step two ($12,000 less $11,400

allocated under step one). With only $600, step two results in an allocation of 1.44 percent of excess compensation.

Compare this allocation with the similar allocation under the two-step formula. The HCE's allocation is less here ($10,290 vs. $10,510). The two-step formula allocates the contribution on the basis of combined compensation, to maximize the disparity resulting in the HCE's favor. The lesser the total contribution amount, the more disparity is lost under the three-step formula. If the amount to be allocated were less than $11,400 (i.e., the maximum allocation under step one of this formula), there would be no permitted disparity utilized for that year under the three-step formula.

Four-step Formula

The four-step formula approach incorporates the top-heavy minimum benefit requirement into the formula. Where the amount to be allocated under the two-step formula is very small, it is possible the resulting allocation may not satisfy the top-heavy minimum allocation requirement under IRC §416. For example, suppose the allocation equaled 2 percent of combined compensation. Any employee whose plan year compensation is less than the integration level would receive an allocation of only 2 percent of plan year compensation, which would be less than the 3 percent minimum allocation required under the top-heavy rules. The four-step formula addresses that possibility by ensuring the top-heavy minimum allocation is satisfied in the first step of the formula. It does not, however, take into consideration that the top-heavy minimum may be less than 3 percent if the highest allocation to any key employee is less than 3 percent.

Description of four-step formula. The allocation under a four-step formula is performed as follows:

1. The first step allocates solely on the basis of plan year compensation, up to 3 percent. This is similar to step one of the three-step formula, except it stops at 3 percent, rather than at the maximum disparity percentage. By making this allocation first, the top-heavy minimum allocation is satisfied. Sometimes, certain employees are eligible for the top-heavy minimum contribution, but do not meet the plan's conditions for the regular employer contribution allocation. To address this, some plans are drafted so that all employees entitled to the top-heavy minimum are included in step one, but only employees who satisfy the plan's conditions for the regular allocations are included in steps two through four.

   Also, note that IRC §415 compensation must be used to calculate the top-heavy minimum contribution, whereas any definition of compensation that satisfies IRC §414(s) may be used under a safe harbor permitted disparity formula. In the examples below, we assume the plan is using IRC §415 compensation for allocation purposes. However, if the plan does not normally use IRC §415 compensation to determine allocations, the plan might be drafted to use IRC §415 compensation solely for the step one allocation (which takes care of the top-heavy minimum), and then to use another IRC §414(s) compensation definition to perform the rest of the allocation.

2. Step two allocates solely on the basis of excess compensation, up to 3 percent. This is similar to step two of the three-step formula, except it stops at 3 percent, rather than at the maximum disparity. This part of the allocation recognizes that, by allocating 3 percent of plan year compensation under the first step, a disparity

of at least 3 percent will satisfy IRC §401(l). Remember, the disparity cannot exceed the lesser of the base contribution percentage or the maximum disparity percentage. Because step one has established a base contribution percentage of 3 percent, the disparity that can be generated from step two is limited to 3 percent.

3. Step three allocates on the basis of combined compensation, in the same manner as the two-step formula, except the allocation cannot exceed the normal maximum percentage reduced by 3 percent to take into account the 3 percent of the maximum permitted disparity that has been used up in step two. For example, if the integration level is the TWB, the normal maximum disparity percentage is 5.7 percent. Because 3 percent disparity has already been used under step two, the step three allocation is limited to 2.7 percent of combined compensation. If the amount to be allocated is sufficient to reach the limit under step three, maximum disparity has been utilized for the plan year.

4. Step four is the standard pro rata formula, based on plan year compensation. It is the same as step two of the two-step formula and step three of the three-step formula. If the amount to be allocated is sufficient to reach at least step three, the resulting allocation produces the same disparity as the two-step formula would produce (subject to issues addressed above regarding certain employees that might be eligible for only the step one allocation and the possibility that a compensation definition might be used for the step one allocation that is different from the compensation definition used for the other steps of the allocation). The main advantage of the four-step formula is that, for years in which the amount to be allocated would not advance beyond step two of the four-step formula, the formula has built in the top-heavy minimum allocation, while the two-step formula has not.

A top-heavy plan is not required to use the four-step formula. It is also acceptable to use a different formula, such as the two-tier formula, and then have the employer make an additional contribution on behalf of any non-key employee whose allocation fails to satisfy the top-heavy minimum contribution requirement.

Examples illustrating the four-step formula. The following three examples demonstrate how the four-step formula works. In the first two examples, the employer contribution parallels the two examples illustrating the two-step formula and the three-step formula. In the third example, the employer contribution is not sufficient to maximize step two.

EXAMPLE 7-31. Employer Contribution Sufficient to Reach Fourth Step. In this example, the employer contributes $48,000, which is enough to reach step four. This is the same amount that is allocated under **EXAMPLE 7-26** and **EXAMPLE 7-29**.

Employee	Plan Year Comp.	Excess Comp.	Combined Comp.	Step 1 All.	Step 2 All.	Step 3 All.	Step 4 All.	Total All.
HCE	$170,000	$41,600	$211,600	$5,100	$1,248	$5,705	$29,101	$41,154
NHCE	$30,000	$0	$30,000	$900	$0	$810	$5,136	$6,846
Total	$200,000	$41,600	$241,600	$6,000	$1,248	$6,515	$34,237	$48,000

At this contribution level, there is no difference between the contribution allocation above and those in the two-step and three-step formulas. By the time step four is reached, the maximum permitted disparity has been achieved, and the allocation under step four is

a pro rata allocation formula, based on plan year compensation, just like step two of the two-step allocation method and step three of the three-step allocation method.

EXAMPLE 7-32. Employer Contribution Not Sufficient to go Beyond Step Three. Under this example, the employer's total contribution is $12,000. This is enough to reach step three, but not enough to maximize the step three allocation. It is through step three that the maximum permitted disparity is achieved. If the contribution is not enough to go on to step four, but enough to reach step three, the allocation is the same as under the two-step formula. The contribution allocation is more favorable for the HCE than the three-step formula, because step three, just like step one of the two-step formula, is designed to achieve the greatest disparity possible from the contribution that is made.

The maximum that can be allocated under the first two steps is $7,248. So long as the employer's contribution is greater than $7,248, the allocation method will reach at least step three, resulting in the same allocation results as under the two-step formula.

EXAMPLE 7-33. Employer Contribution Not Sufficient to go Beyond Step Two. If the employer's contribution is fully allocated within the first two steps (a contribution of less than $7,248), the allocation for the HCE will be less than under the two-tier formula. However, the top-heavy minimum contribution is being taken care of in step one, so there will no additional employer contribution needed to satisfy the top-heavy requirements. If the plan uses the twostep formula, it is possible that the top-heavy minimum contribution will not be satisfied for one or more employees. Suppose the employer contributes only $6,300.

Employee	Plan Year Comp.	Excess Comp.	Combined Comp.	Step 1 All.	Step 2 All.	Step 3 All.	Step 4 All.	Total All.
HCE	$170,000	$41,600	$211,600	$5,100	$300	$0	$0	$5,400
NHCE	$30,000	$0	$30,000	$900	$0	$0	$0	$900
Total	$200,000	$41,600	$241,600	$6,000	$300	$0	$0	$6,300

Imputing Permitted Disparity

Imputing permitted disparity means the plan is relying on the general test under the IRC §401(a)(4) regulations to show the plan is nondiscriminatory, and is adjusting the allocation rates or benefit rates used in that test to take into account employer-provided Social Security contributions or benefits.

PLANS INELIGIBLE TO USE PERMITTED DISPARITY

Section 401(k) and 401(m) Arrangements

The portion of a plan that is a 401(k) arrangement or a 401(m) arrangement may not use permitted disparity to show that the arrangement is nondiscriminatory. The ADP test under IRC §401(k)(3)

is the exclusive means of showing a 401(k) arrangement is nondiscriminatory. The ACP test under IRC §401(m)(2) is the exclusive means of showing a 401(m) arrangement is nondiscriminatory.

ESOPS

An ESOP, or a portion of a plan that is an ESOP, may not use permitted disparity to show nondiscrimination.[30]

If You're Curious …

Self-employed Individuals

For purposes of using the permitted disparity rules, a self-employed individual is treated as having wages under IRC §3121(a) if he or she is subject to self-employment taxes under IRC §1401. The self-employment tax under IRC §1401 is actually equal to the employer and employee portions of the FICA tax under IRC §3101, because the self-employed individual must pay both portions of the tax. To maintain uniformity between self-employed individuals and employees, the permitted disparity rules are applied to self-employed individuals as if they were employees subject to FICA.[31] Therefore, only the employer contribution portion that would apply if the self-employed individual were a common law employee is taken into account. Under the safe harbor method for using permitted disparity to determine contributions or benefits, the self-employed individual is subject to the same formula as a common law employee. When imputing permitted disparity, the same imputing formula is used to adjust the allocation rate or benefit rate of a self-employed individual that is used to adjust the rates for common law employees.

7.04: The General Test for Defined Contribution Plans (Rate Group Testing)

OVERVIEW OF GENERAL TESTING

If a plan does not meet the requirements for one of the safe harbors, it still may be nondiscriminatory under IRC §401(a)(4). The plan contribution allocations are subject to an objective, numerical test. This is called general testing in the Treasury regulations.

In simplest terms, **general testing** is a method of demonstrating that plan allocations or plan benefits are nondiscriminatory by dividing employees into rate groups, and then analyzing each rate group separately. Each rate group passes this nondiscrimination test if it can satisfy one of the coverage tests under IRC §410(b), either the ratio percentage test or the average benefit test. The objective numerical testing rules under IRC §401(a)(4) provide no room for a facts-and-

[30] Treas. Reg. §1.401(l)-1(a)(4)(ii).
[31] Treas. Reg. §1.401(l)-1(a)(4)(i).

circumstances test under which a plan that fails the mathematical tests can argue that the plan is, nonetheless, nondiscriminatory.

Under IRC §401(a)(4), a plan may not discriminate in the amount of benefits or contributions provided. This language has been interpreted by the IRS to mean that nondiscrimination can be evaluated on the basis of contributions and forfeitures allocated during the year (i.e., on a contributions basis), or on the basis of the projected benefits at retirement (i.e., on a benefits basis). The ability to test under either of these options extends to both defined benefit and defined contribution plans.

The customary way of examining nondiscrimination in a defined contribution plan is to review and compare the contribution rates of participants. If a defined contribution plan uses the benefits basis analysis to determine nondiscrimination, it is called cross-testing (i.e., the tester is "crossing" the line between defined contribution and defined benefit plans to use an analysis that is normally used for the other type of plan). Plans that use this method are also called new comparability plans, a name that is a throw-back to a now obsolete revenue ruling that was issued in 1981. Similarly, a defined benefit plan that is being tested on the basis of the equivalent contributions is being cross-tested for nondiscrimination.

DETERMINING RATE GROUPS

As noted above, the first step of general testing is to identify the rate groups. To determine rate groups, a defined contribution plan first must express each participant's allocation of employer contributions and forfeitures as an allocation rate (for an analysis on the basis of contribution allocations) or an equivalent benefit accrual rate (EBAR) (for an analysis on a benefits basis).

When allocation rates are determined, only the nonelective contributions and forfeitures allocated for the plan year are taken into account. When EBARs are determined, the calculation may take into account contributions and forfeitures allocated for prior years.

A few preliminary points . . .

- ***Consistency required.*** The same method of expressing rates must be used for all participants. In other words, the plan cannot express some allocations as allocation rates and others as EBARs.[32]
- ***Elective deferrals and matching contributions are disregarded in determining rate groups.*** Although 401(k) contributions are technically treated as employer contributions,[33] the determination of allocation rates or EBARs does not include increases in the account balance attributable to elective deferrals. The ADP test under IRC §401(k) is the exclusive nondiscrimination test for these contributions. Similarly, matching contributions provided by the employer are disregarded in making these determinations because the ACP test under IRC §401(m) is the exclusive nondiscrimination test for these contributions.[34]

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[32] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii).
[33] IRC §402(e)(3).
[34] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(B).

- ***ESOPs.*** ESOPs may not perform general testing on a benefits basis (i.e., no cross-testing).[35] Thus, the ESOP must use allocation rates to perform general testing.

Determining Allocation Rates

Allocation rates may be expressed as dollar amounts or percentages of plan year compensation. Usually, percentages of plan year compensation are used. The percentage is determined by simply dividing the amount of the contribution and forfeiture allocation by the employee's plan year compensation.

Plan year compensation is determined in the same manner as discussed under the safe harbor rules, meaning that IRC §414(s) compensation must be used, and compensation must be measured for the plan year (or the portion of the plan year the employee is a participant) or for a uniform 12-month period ending in the plan year. The plan will not necessarily use the same definition of compensation to allocate employer contributions as it does to determine allocation rates for nondiscrimination testing purposes.

EXAMPLE 7-34. Allocation Rate for Midyear Entrant. Suppose that Kelly became a participant in his employer’s plan on the July 1 entry date for the current plan year. His plan year compensation may be calculated as IRC §414(s) compensation for his period of participation. If his plan year compensation from July 1 through December 31 is $18,000 and the employer contributed $2,000 to his account, his allocation rate would be $2,000/$18,000, or 11.11 percent, for rate group testing purposes.

Earnings added to the participant’s account for the plan year are not included in determining allocation rates.[36] In other words, IRC §401(a)(4) is testing only the increase in the participant’s account balance due to the allocation of employer nonelective contributions and forfeitures.

Determining EBARs

EBARs are determined by expressing the allocation as an annual benefit payable as a single life annuity at the employee’s testing age.[37] This process is known as **normalizing the benefit**.[38] Under the normalizing process, contributions are projected to normal retirement based on an assumed rate of interest (by multiplying them by an actuarial factor), and then that normal retirement lump sum is converted to a monthly benefit payable for the participant’s lifetime (by being multiplied by a normalization factor). The EBAR is then expressed either as a percentage of average annual compensation (most common) or as a dollar amount.

The process of normalizing benefits is based on the principles of the time value of money—in other words, it takes into account that money earns interest over time. A younger participant has more years to retirement than does the older participant, and therefore has more time to accrue

[35] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii)(A).
[36] Treas. Reg. §1.401(a)(4)-2(c)(2)(iii).
[37] Treas. Reg. §1.401(a)(4)-8(b).
[38] Treas. Reg. §1.401(a)(4)-12.

interest on today's contribution before retirement. An allocation today to the account of a younger employee will produce a larger benefit at retirement than will the same allocation to the account of an older employee. As a result, higher contribution rates for older HCEs will not necessarily cause the plan to be discriminatory, because on a projected benefits basis, many of the younger employees are actually receiving much greater benefits at retirement, even if their current contribution levels are lower than that of the HCEs.

Identifying the Rate Groups

Once the allocations are converted into allocation rates or EBARs, the rate groups are then identified by reference to the rate of each HCE. An HCE's rate group includes all employees (HCEs and NHCEs) who have a rate equal to or greater than the HCE's rate.

EXAMPLE 7-35. Determining Rate Groups. A profit-sharing plan is being tested using allocation rates. There are three HCEs with the following allocation rates:

HCE #1: 11%
HCE #2: 9%
HCE #3: 5%

The plan has three rate groups, one corresponding to each HCE's allocation rate. The 11 percent rate group includes HCE #1 and all NHCEs that have an allocation rate equal to or greater than 11 percent. The 9 percent rate group includes HCE #1 and HCE #2, because each has an allocation rate equal to or greater than 9 percent, and all NHCEs that have an allocation rate equal to or greater than 9 percent. The 5 percent rate group includes all three HCEs and all NHCEs that have an allocation rate equal to or greater than 5 percent.

EXAMPLE 7-36. Two HCEs with Equal Allocation Rates. Suppose, in the prior EXAMPLE 7-35, that HCE #2 also has an allocation rate of 11 percent. Now there are only two rate groups to test: the 11 percent rate group (which includes HCE #1 and HCE #2) and the 5 percent rate group (which includes all three HCEs).

EXAMPLE 7-37. Rate Group Determination with EBARs. Suppose the plan in EXAMPLE 7-35 is cross-tested. The participants' allocations would be converted into EBARs for rate group testing purposes. Suppose the resulting EBARs for the HCEs are as follows:

HCE #1: 6.33%
HCE #2: 11.2%
HCE #3: 9.24%

There are three rate groups to test, one corresponding to each HCE's EBAR. The 11.2 percent rate group includes HCE #2 and all NHCEs with an EBAR equal to or greater than 11.2 percent. The 9.24 percent rate group includes HCE #2 and HCE #3 and all NHCEs with an EBAR equal to or greater than 9.24 percent. The 6.33 percent rate group includes all three HCEs and all NHCEs with an EBAR equal to or greater than 6.33 percent.

Cross-Testing Gateways

Treasury regulations require defined contribution plans to satisfy a **gateway test** as a precondition to demonstrating that allocations are nondiscriminatory on a benefits basis (i.e., through cross-testing).[39] This is referred to as a gateway test, because the plan first has to meet this requirement before being permitted to enter into cross-testing, as if this precondition was the gate that opens the cross-testing door.

The Minimum Allocation Gateway

Under the minimum allocation gateway, the lowest permissible allocation rate for any NHCE who benefits under the plan is one-third of the highest allocation rate for any HCE who benefits under the plan.[40] This is also referred to by practitioners as the one-third test. However, if each NHCE receives an allocation that is no less than 5 percent of IRC §415 compensation, the gateway is deemed satisfied.[41] This is referred to by practitioners as the 5 percent test. Thus, for plans that are designed to provide an allocation to each eligible NHCE that equals or exceeds 5 percent of compensation, the gateway tests are automatically met and are not an issue.

The minimum allocation gateway does not require that the plan document guarantee the minimum contribution. So long as the allocation to all of the NHCEs satisfies the gateway, the plan may proceed with cross-testing. This is important, because most of these plans are profit-sharing plans under which the employer makes discretionary contributions to two or more separate allocation groups, and the minimum contribution rate made for any of the allocation groups is determined at the employer's discretion each year.

EXAMPLE 7-38. Minimum Allocation Gateway. A profit-sharing plan provides for two allocation groups: Group A consists of owners of the company, who are all HCEs, and Group B consists of other eligible employees. The employer makes a discretionary contribution for each group.

The allocation rate for Group A [using a definition of compensation that satisfies IRC §414(s)] is 20 percent. To pass the minimum allocation gateway and be permitted to use testing on a benefits basis to meet IRC §401(a)(4), each NHCE's

[39] Treas. Reg. §§1.401(a)(4)-8(b)(1), 1.401(a)(4)-9(b)(2), and 1.401(a)(4)-9(c)(3), 66 F.R. 34535 (June 29, 2001).
[40] Treas. Reg. §1.401(a)(4)-8(b)(1)(vi)(A).
[41] Treas. Reg. §1.401(a)(4)-8(b)(1)(iv)(B).

allocation rate (using the same definition of compensation) must be no less than the lesser of:

- 6.67 percent of compensation (i.e., ⅓ of the Group A allocation rate of 20 percent); or
- 5 percent of each NHCE's IRC §415 compensation.

Because 5 percent is less than 6.67 percent, the employer needs only to contribute 5 percent or more on behalf of each NHCE who receives an allocation, and the minimum allocation gateway is met.

If the employer could not afford to make a contribution equal to at least the minimum gateway, it could decide to adjust the allocation percentage for Group A so that cross-testing is not needed to demonstrate nondiscrimination.

Compensation Used in Determining Minimum Allocation Gateway

The compensation definition under the 5 percent test is different from the compensation definition for the one-third test.

Compensation for one-third test. The one-third test is based on the allocation rate. An employee's allocation rate is the percentage obtained by dividing the employee's allocation for the plan year derived from employer nonelective contributions (other than matching contributions) and forfeitures, divided by his or her plan year compensation.[42] Plan year compensation, in turn, may be any definition of compensation that satisfies IRC §414(s).

Compensation for 5 percent test. The 5 percent test, on the other hand, must be determined on the basis of IRC §415 compensation. Although IRC §415 compensation also satisfies the definition of IRC §414(s) compensation, IRC §414(s) is a much broader category of compensation definitions, and can exclude items of compensation that must be included under IRC §415.

IRC §415 compensation includes essentially all types of compensation that are part of gross income, as well as all elective contributions under IRC §401(k) and IRC §403(b), salary reduction contributions under a cafeteria plan (IRC §125) and salary reduction amounts to purchase qualified transportation fringe benefits (IRC §132(f)(4)). In other words, because a 5 percent allocation rate might be substantially less than the allocation rate given to some or all of the HCEs, Treasury wants to ensure that the maximum amount of compensation possible is taken into account for the nondiscrimination testing.

As a result, if the plan uses a non-IRC §415 definition of compensation to allocate employer contributions, the determination of whether the 5 percent test is satisfied will not be as simple as determining whether the participant's allocation rate is at least 5 percent.

Partial-year compensation may be used for both the one-third test and the 5 percent test. Final regulations allow the 5 percent test to be satisfied by limiting compensation to the portion of the

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[42] Treas. Reg. §1.401(a)(4)-2(c)(2).

plan year during which the participant is eligible. This will simplify the determination of whether the 5 percent test is satisfied for plans that limit compensation in this fashion.[43]

Benefiting Participants Must Receive Gateway

Only participants who benefit under the plan for coverage testing purposes[44] must receive the gateway contribution. For example, if the plan requires employment on the last day of the plan year to receive an allocation, participants who fail to benefit because of the last-day rule would not have to receive the gateway contribution (assuming the plan otherwise passes coverage).

Caution: special nonelective contributions [e.g., top-heavy contributions, QNECs and nonelective contributions used to satisfy the safe harbor 401(k) rules under IRC §401(k)(12) or under IRC §401(k)(13)] may expand the group of employees who benefit under the plan and must receive the gateway contribution.

If You're Curious …

The plan being tested consists of all nonelective contributions made by the employer (whether on a required or discretionary basis), unless a portion of the plan is properly disaggregated.

Top-heavy minimum contributions. All non-key employees who are participants in a top-heavy plan are required to receive a minimum contribution, pursuant to IRC §416(c), unless the top-heavy minimum is satisfied in a separate plan. A plan may require a non-key employee to be employed on the last day of the plan year to qualify for the top-heavy minimum contribution, but may not require a minimum number of hours of service (e.g., 1,000 hours) for the plan year.[45]

If a non-key employee who is an NHCE qualifies for a top-heavy minimum contribution, but not for any other nonelective contributions made by the employer for the plan year, the plan would not satisfy the gateway contribution requirement if the gateway for the plan year is greater than 3 percent. This might preclude the plan from cross-testing.

- **QNECs.** If the plan includes a 401(k) arrangement, the employer might decide to make QNECs to satisfy the ADP test or the ACP test. Although QNECs are used to pass the separate nondiscrimination tests, which apply to disaggregated portions of the plan, the QNECs are, nonetheless, part of the plan that consists of the employer's nonelective contributions and must satisfy IRC §401(a)(4) together with the other nonelective contributions. In fact, the plan is required to satisfy IRC §401(a)(4) both with and without the QNECs being taken into account.[46]

  If the employer is intending to use cross-testing to show that its nonelective contributions satisfy IRC §401(a)(4), an NHCE who benefits only from the

[43] Treas. Reg. §1.401(a)(4)-8(b)(1)(vi)(B).
[44] See Treas. Reg. §1.410(b)-3.
[45] Treas. Reg. §1.416-1, M-10.
[46] Treas. Reg. §§1.401(k)-2(a)(6)(ii) and 1.401(m)-2(a)(6)(iii).

QNECs portion of the employer's nonelective contributions to the plan is required to receive the gateway contribution.

- **Safe harbor contributions under IRC §401(k)(12).** One of the ways a 401(k) arrangement may be exempt from the ADP test is for the plan to satisfy the safe harbor 401(k) rules under IRC §401(k)(12) or under IRC §401(k)(13). As a condition for safe harbor treatment, the employer must make a safe harbor contribution for the eligible NHCEs. The safe harbor contribution may be in the form of a matching contribution or a nonelective contribution. If the safe harbor contribution is a match, it will not impact the gateway requirement because matching contributions are not part of the same plan for nondiscrimination testing purposes as the nonelective contributions.

But if the safe harbor contribution is a nonelective contribution, it does impact the gateway requirement. Under IRC §401(k)(12)(C), an eligible NHCE in the 401(k) arrangement must receive the safe harbor nonelective contribution regardless of whether the employee is employed on the last day of the plan year or has earned a minimum number of hours of service for the plan year. Therefore, if an NHCE qualifies only for the safe harbor nonelective contribution (which is usually 3 percent of compensation) and not for any other portion of the employer's nonelective contribution to the plan, then the NHCE is benefiting under the plan that consists of the employer's nonelective contributions and must receive the gateway contribution if the nonelective contributions are going to be cross-tested to satisfy IRC §401(a)(4).

So long as any of the contributions described above are part of the same plan that includes other nonelective contributions that the employer intends to cross-test, the NHCEs who benefit from such contributions are also required to get the gateway.

Matching Contributions Cannot be Used to Satisfy Gateway Contribution

Matching contributions made by the employer (e.g., matching contributions on elective contributions) are not eligible to be used to satisfy the gateway contribution requirement. This is because matching contributions are part of an IRC §401(m) arrangement, which is not eligible to be aggregated with employer nonelective contributions under a profit-sharing plan to satisfy IRC §401(a)(4).

Safe Harbor 401(k) Plans Can Help Meet the Minimum Gateway Allocation

Sometimes the employer maintains a safe harbor 401(k) plan in addition to (or as part of) a cross-tested profit-sharing plan. If the profit-sharing contributions are tested on the basis of EBARs, and the minimum gateway allocation has to be satisfied, the safe harbor nonelective contribution under the safe harbor 401(k) rules is permitted to be included in the determination of whether the gateway is satisfied.

EXAMPLE 7-39. Safe Harbor 401(k), Cross-testing Combination Plan. An employer maintains a new comparability profit-sharing plan with a safe harbor 401(k) arrangement. To satisfy the 401(k) safe harbor, the employer provides the 3 percent safe harbor nonelective contribution (based on IRC §415 compensation). In addition, a discretionary profit-sharing plan is provided using

the plan design described in EXAMPLE 7-38 (Group A consists of owners, Group B consists of all other eligible employees).

The 3 percent safe harbor nonelective contribution may be counted in determining whether the Group B participants satisfy the gateway test. If the employer wants to satisfy the 5 percent gateway test, it simply needs to make sure that the profit-sharing allocation for the eligible NHCEs is at least 2 percent of IRC §415 compensation (because the 3 percent safe harbor nonelective contribution is also based on IRC §415 compensation).

If the employer contributes both safe harbor nonelective contributions and regular nonelective contributions to a safe harbor 401(k) plan, the gateway contribution must be provided to all NHCEs who benefit under the plan. The plan consists of the total amount of nonelective contributions (safe harbor and regular) made by the employer to the safe harbor 401(k) plan.[47] If there are different accrual and/or eligibility requirements for the safe harbor and regular nonelective contributions, the gateway contribution will need to be provided to any participant who benefits under the safe harbor nonelective contribution but fails to otherwise benefit under the additional nonelective contribution (unless such participant is part of a disaggregated group), or the rate group test may not be performed on a benefits basis.

CROSS-TESTING THE RATE GROUPS

Once the rate groups are determined, the actual rate group testing can be performed. To be considered nondiscriminatory, every rate group in the plan must satisfy the coverage requirements of §410(b). Both the ratio percentage test and the average benefits test are available for this purpose.

The rate groups do not have to pass the same coverage test. For example, a plan with four rate groups might pass the ratio test with respect to three of the rate groups and the average benefits test with respect to one of the rate groups.

Determining Whether the Ratio Percentage Test Is Met for the Rate Group

To pass the ratio percentage test, the employees included in the rate group must have a coverage ratio of at least 70 percent. The coverage ratio is determined as if the employees in the rate group were the only ones <u>benefiting</u> under the plan.[48] In other words, one must first calculate the ratio percentage for each of the NHCE and HCE groups. For this purpose, the numerator of each ratio is the number of NHCE or HCE employees who are <u>included in the rate group</u>, and the denominator of each ratio is the number of all NHCE or HCE employees in the plan (<u>not counting employees who are excludable for coverage testing purposes</u>).

Excludable employees are employees who have not satisfied the plan's minimum age and service requirements, certain union employees and employees who terminated during the plan year before

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[47] Treas. Reg. §1.401(a)(4)-1(b)(2)(ii).
[48] Treas. Reg. §1.401(a)(4)-2(c)(3)(i).

completing more than 500 hours of service, provided the plan has an hours of service or last day allocation requirement. The denominators, therefore, will pick up all employees who have satisfied the plan's minimum age and service requirements, even if they are excluded from the plan by employment classification or their allocation rate or EBAR is too small to be included in the rate group being tested.

If Any Rate Group Fails the 70 Percent Test

If any rate group fails to meet the 70 percent requirement, there are additional ways in which cross-testing can be used to demonstrate nondiscrimination. In particular, the average benefit test may be used. The mathematics of this test are outside the scope of this textbook. The average benefits test is discussed in detail in The ASPPA Defined Contribution Plan Series Volume 3: Advanced Compliance and Administration Topics.

TYPES OF PLAN DESIGNS USING GENERAL TESTING

In some cases, the plan is not designed specifically to use the general testing method, but general testing becomes necessary because the safe harbor rule is failed for a particular plan year. In other cases, the plan is designed with the specific intention to use general testing.

If You're Curious …

Compensation Definition Is Not a Safe Harbor

As noted in the earlier discussion of design-based safe harbor plans, if the plan does not define compensation for allocation purposes as a safe harbor under IRC §414(s), the compensation definition may fail to satisfy IRC §414(s) for a particular plan year. For such plan year, the general testing method may need to be used to show compliance with IRC §401(a)(4). In that situation, the allocation that results from the use of non-IRC §414(s) compensation is cross-tested, using an allocation rate or EBAR determined with a §414(s)-compliant definition of compensation.

Allocations Based on Points

If the plan allocates contributions and forfeitures on the basis of points, the only testing methods available are the nondesign-based safe harbor, if the plan is a uniform points plan, or general testing. If the plan is a uniform points plan, general testing would be used only if the plan could not satisfy the average allocation test prescribed by the nondesign-based safe harbor. If the plan determines points in a manner that fails to satisfy the definition of a uniform points plan, general testing would be the only available IRC §401(a)(4) test. To apply the general testing to a points plan, each participant's allocation (as determined under the points formula) would be expressed as an allocation rate or as an EBAR, and the resulting rate groups would be tested under the coverage testing rules.

Remember that, if cross-testing is used (i.e., allocations are converted to EBARs), the gateways must be satisfied. Note, however, that some points plans might be able to satisfy a fourth method of meeting the gateways: the age-based allocation schedule

exception.[49] Under this exception, a points plan may be deemed to meet the gateway if the contributions increase smoothly at regular intervals.

Age-Weighted Plans

An age-weighted plan allocates the employer contributions and forfeitures on the basis of the normalization factors used to determine EBARs under the cross-testing method. Each participant's allocation is based on his or her share of the total normalization factors of all participants. This type of plan is designed with the intention of using general testing.

EXAMPLE 7-40. Age-weighted Allocation. An age-weighted plan covers four participants: one HCE and three NHCEs. There are no other employees. The allocation for the plan year is as follows.

	Age	Compensation	Allocation	Rate	Allocation EBAR
HCE	50	$150,000	$29,793.63	19.86%	8.5%
NHCE 1	40	$35,000	$3,074.81	8.79%	8.5%
NHCE 2	30	$25,000	$971.45	3.89%	8.5%
NHCE 3	28	$20,000	$660.11	3.30%	8.5%
Totals		$230,000	$34,500.00		

(Note: You are not given sufficient information to determine the allocation. The allocation is a given in this example and has been determined actuarially.)

Although not a safe harbor, these plans usually satisfy general testing with little difficulty. By allocating the contribution on the basis of the normalization factors, the plan is designed to produce the same EBAR for each participant. If all participants have the same EBAR, only one rate group needs to be tested. This rate group will pass the coverage test easily unless there are nonexcludable employees who do not benefit under the plan.

The age-weighted plan may run into difficulty under two circumstances:

- if the IRC §415 limits reduce an NHCE's allocation, resulting in a lower EBAR for that participant, or
- if the top-heavy minimum benefit for a non-key participant increases that participant's allocation and the participant is an HCE.

Application of Gateway Rules

Because age-weighted plans are designed specifically to be cross-tested (i.e., allocations are converted to EBARs for IRC §401(a)(4) testing purposes), these plans are subject to the gateway rules.[50] Most age-weighted plans are able to satisfy an age-based allocation schedule exception to the minimum allocation gateway, because the allocation rates differ solely on the basis of age. If that is the case, then the plan shown above would be able to

[49] Treas. Reg. §1.401(a)(4)-8(b)(1)(iv).
[50] Treas. Reg. §1.401(a)(4)-8(b)(1).

use cross-testing, even though the allocation rates provided to NHCE2 and NHCE3 do not satisfy the minimum allocation gateway.

Other Plans Designed to Use Cross-Testing (New Comparability Plans)

The age-weighted plan is not the only plan design intended to be cross-tested. Allocation formulas in many plans are designed to produce greater allocation rates for a target group of participants. The target group might be identified by job classification (e.g., HCEs, salaried employees, officers, managers, a particular division), compensation levels (e.g., employees with compensation exceeding a specified dollar amount) or other objective criteria (e.g., employees over age 50, employees with at least ten years of service).

If general testing were applied on the basis of allocation rates, the plan often fails because the target group is usually made up of a disproportionate percentage of HCEs. But if the plan is cross-tested, the rate group testing method is based on EBARs, and IRC §401(a)(4) can be satisfied on a benefits basis. These formulas work best when the average age of the target group is greater than the average age of the other employees. The greater the spread in the average age, the more this design favors the target group and the more dramatic are the results—a greater spread of allocation rates in favor of the target group.

Separate Discretionary Contributions for Specified Allocation Groups (Tiered Allocations)

This is perhaps the most common approach taken to cross-tested plan designs when the plan is a profit-sharing plan. The plan is written so that the eligible participants are divided into separate allocation groups. This might be as simple as two allocation groups (e.g., NHCEs and HCEs), or there might be multiple groups (e.g., owners, nonowner managers and other employees). The plan gives the employer the discretion to determine the annual contribution amount for each allocation group.

The discretionary contribution made for a particular group is allocated only to the members of that group under a definite allocation formula (e.g., a pro rata allocation based on compensation). The idea is that, if the allocation rates for the HCEs are greater than the allocation rates for the NHCEs, cross-testing will be used to show the plan is nondiscriminatory. Usually, a third-party service provider is retained to perform the nondiscrimination test calculations, and to give the employer contribution limits for the allocation groups that include at least one HCE.

Although the plan may permit the employer to declare separate discretionary contributions for each allocation group, the manner in which the allocations are determined must be specified in the plan document. The allocation groups must be defined using objective criteria in a manner that precludes employer discretion, or the plan will fail to satisfy the definite allocation formula requirement.

The employer will typically design the plan in a way to have the most control over providing desired contribution levels to particular groups of employees. If the employer wants to use the cross-tested plan design to increase the allocation rates of its more long-term employees, who might be primarily highly compensated, the employer might identify allocation groups on the basis of length of service (e.g., Group 1 includes employees with 20 or more years of service, Group 2

includes employees with 15-19 years, Group 3 has employees with 10-14 years, Group 4 includes employees with 5-9 years and Group 5 contains employees with fewer than five years). If the employer wants to target contribution levels on the basis of job categories, it will define groups on that basis (e.g., each operating division is a separate group, or management and supervisory employees might be in a separate allocation group from other employment classifications).

Separate Allocation Group for Each Employee

Some practitioners define a different allocation group for each employee. Although some practitioners were concerned that this would raise issues with the IRS, such has not been the case. In fact, the IRS has permitted this practice in master/prototype plans.

If You're Curious …

The designation of an individual employee as a separate group raises a second issue that might be important. In particular, when there is a separate group for each employee, it might be construed by the IRS as a deemed cash or deferred arrangement (CODA). This is an issue if the IRS were to determine that the employee controls the amount of employer contribution made on his or her behalf (e.g., a principal owner of a corporate sponsor) and the employee's current compensation is adjusted accordingly.[51] A determination letter would not necessarily protect the plan on this issue, because whether a deemed CODA exists is generally an operational issue, not a form issue. The deemed CODA issue creates some practical problems for certain businesses, and it is unclear how diligently the IRS would pursue this issue in otherwise acceptable plan designs. For example, if the owner of the business is the only HCE, application of the deemed CODA rule would seem to unfairly single out this type of business merely because an allocation group defined to include all HCEs includes only one person.

Employer must give written direction on how to allocate contribution. The IRS' field directive on separate discretionary contributions for different allocation groups notes that the plan must require the employer to designate in writing how much of its contribution is for each group. It is not clear when this designation needs to be given. For example, could the employer make a single sum contribution and then, at a later date, provide direction to the plan administrator as to how to divide the contribution among the separate groups? The answer is not clear. To be safe, the employer should wait until the amount for each group is determined before it makes the contribution, and then provide direction with the contribution. Written direction could take the form of a separate letter, the acceptance of a proposed allocation report that shows how the nondiscrimination test would be satisfied, or an entry in the memo section of the contribution check.

[51] Treas. Reg. §1.401(k)-1(a)(3) and the discussion of deemed CODAs in IRS Announcement 94-101.

7.05: Review of Key Concepts

- What are the two ways to approach IRC §401(a)(4) nondiscrimination testing?
- Explain how certain contributions are tested separately for nondiscrimination purposes.
- What is a design-based safe harbor plan?
- What is a nondesign-based safe harbor plan?
- Identify some of the plan provisions that will not affect reliance on the IRC §401(a)(4) safe harbor.
- What is permitted disparity and why is it considered nondiscriminatory?
- Identify the types of plans that may and may not use permitted disparity.
- What integration levels are permitted in plans?
- What is the maximum disparity allowance?
- Describe general testing and which types of plans use general testing.
- What is another name for general testing?
- How are rate groups determined?
- What are the gateway requirements?
- When do the gateway requirements apply to a plan?
- What is cross-testing?
- Describe a new comparability allocation formula.

7.06: For Practice – True or False

1. The integration level must be a definitely determinable amount stated in the plan document.
2. Defined contribution plans must satisfy nondiscrimination requirements either by a safe harbor plan design or by general testing on a contributions basis.
3. If a plan reallocates forfeitures on an integrated basis, it may use the 5.7 percent integration limit only once for the combination of the forfeitures and contributions to the plan.
4. If the integration level is less than 20 percent of the TWB in effect at the beginning of the plan year, the maximum disparity allowance is 5.7 percent.
5. The TWB is the maximum amount of earnings in any calendar year that may be considered wages for Social Security OASDI purposes.
6. Plans that include new comparability allocation formulas are, by design, safe harbor contribution formulas.
7. A safe harbor plan may be design-based or nondesign-based.
8. Employer matching contributions are not considered when determining rate groups.
9. The gateway test is a precondition to using cross-testing to satisfy nondiscrimination requirements.

10. If all NHCEs receive an allocation of at least 5 percent of IRC §415 compensation, the plan will satisfy the gateway requirements.

7.07: Sample Test Questions

1. All of the following statements regarding permitted disparity are TRUE, EXCEPT:

   A. A top-heavy plan must provide the minimum required top-heavy contribution, even if it is more than the amount allocated under the permitted disparity formula.
   B. The permitted disparity allocation formula must be specified in the plan document.
   C. The ESOP portion of a plan may use permitted disparity.
   D. The integration level must be prorated if the plan year is less than 12 months and compensation is limited to the short period.
   E. Permitted disparity may be considered a safe harbor plan design.

2. All of the following are valid permitted disparity formulas, EXCEPT:

   - Note: The TWB for 2018 is $128,400.

   A. 3.0 percent of compensation plus 3.0 percent of compensation in excess of $60,000
   B. 5.7 percent of compensation plus 5.7 percent of compensation in excess of $128,400
   C. 5.7 percent of compensation plus 4.3 percent of compensation in excess of $55,000
   D. 5.7 percent of compensation plus 5.4 percent of compensation in excess of $75,000
   E. 5.7 percent of compensation plus 4.3 percent of compensation in excess of $34,000

3. Based on the following information, determine the members of Participant B's rate group for general testing under IRC §401(a)(4):

Participant	Status	Allocation Rate
A	HCE	9%
B	HCE	8%
C	HCE	6%
D	NHCE	9%
E	NHCE	8%
F	NHCE	6%
G	NHCE	5%

   A. Participants B and E only
   B. Participants B, D and E only
   C. Participants A, B, D and E only
   D. Participants B, C, E, F and G only
   E. Participants A, B, C, D, E and F only

4. All of the following statements regarding general testing are TRUE, EXCEPT:

   A. Rate group testing is another name for general testing.
   B. Each rate group must satisfy one of the coverage tests under IRC §410(b).

C. Defined benefit plans that satisfy general testing on a contributions basis are cross-tested.
D. Rate groups are determined by comparing allocation rates (contributions) or EBARs (benefits).
E. Elective contributions are included in determining rate groups.

5. All of the following statements regarding gateway testing are TRUE, EXCEPT:

A. The one-third test is satisfied if the allocation rate for any NHCE who benefits under the plan is at least one-third of the highest allocation rate for any HCE who benefits under the plan.
B. Plans that satisfy the gateway requirements are deemed to satisfy the general test under IRC §401(a)(4).
C. The definition of compensation may differ in the one-third test and the 5 percent test.
D. The 5 percent test is satisfied if each NHCE receives an allocation of at least 5 percent of IRC §415 compensation.
E. Compensation from date of participation may be used for gateway testing.

6. Based on the following information, determine the allocation to Participant B:

- The plan is a calendar year profit-sharing plan.
- The employer does not sponsor any other plans.
- The TWB for 2018 is $128,400.
- The integration level is $128,400.
- Participant B's compensation for the plan year is $150,000.
- The employer has elected to make an allocation of 3% of total compensation plus 3% of excess compensation.

A. $4,500
B. $5,148
C. $7,110
D. $8,055
E. $9,000

7. Which of the following statements regarding reliance on safe harbors is/are TRUE?

I. The use of multiple entry dates does not cause the plan to fail to be a design-based safe harbor plan.
II. A participant's allocation can be limited to a specified dollar amount or percentage of plan year compensation without violating the safe harbor rules.
III. Any plan provision that results in a lower allocation for one or more HCEs does not affect the plan's status as a design-based safe harbor plan, even though such provision does not apply uniformly to all employees.

A. I only
B. III only
C. I and II only
D. II and III only
E. I, II and III

8. Which of the following is/are design-based safe harbor allocation formulas under IRC §401(a)(4)?

   I. An employer contribution of $100 for every week of service in the plan year
   II. An employer contribution of $500 for every month of service in the plan year
   III. Pro rata based on points for service and compensation

   A. I only
   B. III only
   C. I and II only
   D. II and III only
   E. I, II and III

9. Which of the following statements regarding new comparability plans is/are TRUE?

   I. A new comparability formula may satisfy a design-based safe harbor and avoid nondiscrimination testing.
   II. A new comparability plan gives the employer the discretion to determine the annual contribution level for each allocation group.
   III. The target group in a new comparability plan may be identified by job classification, compensation levels or other objective criteria.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

10. Which of the following statements regarding nondiscrimination testing is/are TRUE?

   I. General testing is used to show satisfaction of nondiscrimination requirements when a plan does not use a safe harbor plan design.
   II. If more than 70% of the rate groups satisfy nondiscrimination requirements, the plan satisfies IRC §401(a)(4).
   III. Forfeiture allocations are not considered when determining rate groups.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

See next page for answers to the true/false and sample test questions.

7.08: Solutions to True or False Questions

1. True.
2. False. Defined contributions may also satisfy nondiscrimination requirements by testing on a benefits basis. This is known as cross-testing.
3. True.
4. True.
5. True.
6. False. New comparability formulas do not meet safe harbor requirements, and therefore use general testing (rate group testing) to satisfy nondiscrimination requirements.
7. True.
8. True.
9. True.
10. True.

7.09: Solutions to Sample Test Questions

1. The answer is **C**. ESOPs are not permitted to use permitted disparity allocation formulas.
2. The answer is **D**. The integration level of $75,000 is 58.41 percent of the 2018 TWB, so the maximum disparity allowance needs to be reduced from 5.4 percent to 4.3 percent.
3. The answer is **C**. Participant B's allocation rate is 8%. An HCE's rate group includes all employees (HCEs and NHCEs) who have a rate equal to or greater than the HCE's rate. Thus, Participants A, B, D and E are all members of the rate group.
4. The answer is **E**. Elective contributions are not considered when determining rate groups.
5. The answer is **B**. Gateway requirements are a precondition to being able to cross-test for nondiscrimination purposes. General testing is still required to show nondiscrimination requirements are satisfied.
6. The answer is **B**. Total compensation of $150,000 x 3% = $4,500. Excess compensation is $150,000 minus the $128,400 integration level which equals $21,600. $21,600 x 3% = $648. Participant B's total allocation is $4,500 + $648 = $5,148.
7. The answer is **E**. All of the statements are true.
8. The answer is **A**. A design-based safe harbor plan may allocate the same dollar per unit of service performed by the participant during the plan year, however, the unit of service may not exceed one week. Thus, an employer contribution of $500 for every month of service in the plan year does not meet a design-based safe harbor. A pro rata allocation based on points for service and compensation is a nondesign-based safe harbor formula.
9. The answer is **D**. New comparability formulas do not satisfy safe harbor nondiscrimination requirements and must perform the general test.
10. The answer is **A**. All of the rate groups must satisfy coverage testing in order for the plan to satisfy the nondiscrimination requirements of IRC §401(a)(4). Forfeiture allocations are included when determining rate groups.

CHAPTER 8:

DISTRIBUTIONS

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8.01: Key Terms

- Account Balance Method
- Alternative defined contribution plan
- Alternate payee
- Annuity
- Annuity Distribution Method
- Designated beneficiary
- Distribution calendar year
- Fixed number of years
- Hardship withdrawal
- Installment
- Lump sum
- Permissible withdrawal
- Primary beneficiary
- Qualified domestic relations order (QDRO)
- Qualified joint and survivor annuity (QJSA)
- Qualified preretirement survivor annuity (QPSA)
- Required beginning date (RBD)
- Required minimum distribution (RMD)
- Severance from employment
- Valuation calendar year

8.02: Introduction

It is very easy to get caught up in all the rules that must be followed to have a proper qualified plan and to forget that the purpose of these plans is the actual provision of retirement benefits to participants.

This chapter discusses the rules surrounding that actual payment of benefits to participants, including such issues as the form in which benefits must be or can be paid, the timing of the payment of benefits, the need in some plans to provide annuity options, the ability of some plans to permit in-service withdrawals on demand or upon the occurrence of some financial hardship and the formalities of paperwork relating to the payment of benefits. Furthermore, this chapter discusses the required minimum distribution rules of Internal Revenue Code (IRC) §401(a)(9), which ensure that the benefits will actually begin to be removed from the plan when the participant attains age 70½, retires or dies with funds in the plan.

This chapter does not discuss tax ramifications of distributions; that is the topic of Chapter 9.

8.03: Distribution Forms

PAYMENT METHODS

A qualified plan must state the payment methods that are available to the participant or beneficiary. A payment method must be either mandatory or subject to the participant's (or beneficiary's) election. The employer, or any other fiduciary or third party, may not have the discretion to choose

the form of payment to be made.[1] In this section, we describe lump sum payments, annuity distributions and installment distributions.

Lump Sum

A **lump-sum** payment is made in a single sum to the participant or beneficiary. In a defined contribution plan, the lump sum is the value of the vested account balance as of the valuation date specified in the plan (usually the latest valuation date that precedes the date of the distribution).

Annuity Distribution

An **annuity** is a payment that is guaranteed for one lifetime or two lifetimes. If the annuity is for one lifetime, the payment period is the participant's life or, in the case of an annuity that commences after the participant's death, the beneficiary's life. If the annuity is for two lifetimes, the payment is for both the participant's life and a surviving beneficiary's life (that is, benefit payments continue while either the participant or the beneficiary is alive).

An annuity for one lifetime is often referred to as a single life annuity or a straight life annuity. An annuity over two lifetimes is often referred to as a joint and survivor annuity. Annuity payments are usually level payments during the individual's lifetime and made on a regular basis, such as monthly, quarterly or annually.

Payment of Annuities from Defined Contribution Plans

A defined contribution plan is not able to pay an annuity directly from the account, because the account balance is subject to investment fluctuations and the annuity must be able to guarantee a stream of payments for the relevant life or lives. If the participant lives longer than his or her life expectancy, or if investment returns are worse than expected, the participant's account could be used up before the participant dies.

As a result, if an annuity is to be paid from a defined contribution plan, the plan administrator or trustee will purchase an annuity contract on the participant's behalf from an insurance company so that payments can be properly guaranteed. The annuity contract may be held by the plan, and the plan can act as a conduit by receiving payments from the insurer and then transmitting them to the participant (or beneficiary), or the contract may be distributed to the participant, who will then receive the annuity payments directly from the insurance company. The latter approach is more common. If the annuity contract is distributed to the participant, it must be a nontransferable

[1] Treas. Reg. §1.411(d)-4, Q&A-4.

annuity, meaning it cannot be sold or otherwise transferred by the participant after distribution to another person.[2]

Qualified Joint and Survivor Annuity Option Might be Required

Certain plans must provide a qualified joint and survivor annuity as a payment option. This will be discussed below.

Annuity with Term Certain Feature

An annuity may be offered that provides a guaranteed payment term, even if the individual dies sooner. For example, a life annuity with ten years certain means the annuity will be paid for the participant's life but, if the participant dies before ten years have passed, the annuity payments will continue for the remainder of the ten-year period following the date on which the annuity payments began. Payments during the guaranteed period that are made after the participant's death are paid to the beneficiary.

Installment Distribution

An **installment** distribution is a periodic payment, such as a monthly or annual payment, that is made for a specified period of time. The installment period might be a specified number of years, such as ten years, or it might be based on a life expectancy period. The life expectancy period might be the participant's life expectancy, or a joint life expectancy of the participant and a beneficiary. The life expectancy period is usually taken from a table referenced in the plan document (e.g., the tables published in Treas. Reg. §1.401(a)(9)-9, which are used for minimum distribution calculations). An installment payment is not guaranteed for any particular lifetime.

A period based on life expectancy is not the same as a guaranteed lifetime payment. For example, suppose a participant's life expectancy is 18 years at the time an installment distribution begins. The installment payments will be made over the 18-year period. If the participant dies before the end of the 18-year period, the remaining payments are made to the beneficiary. If the participant outlives the life expectancy, the installment payments stop after 18 years and no further benefits are paid. If a life annuity were paid instead, the payments would last only as long as the participant is living, and would continue beyond 18 years if the participant lived longer than that. On the other hand, the payments would stop at death, even if the participant died within the first 18 years (i.e., earlier than his or her life expectancy).

Installment Distributions from Defined Contribution Plans

A defined contribution plan may make installment payments directly from the trust. The amount distributed is usually determined by dividing the current vested account balance by the remaining payment term. For example, if a ten-year installment payment is elected, and payments are made annually, the first payment would be one-tenth of the vested account balance, the second payment

[2] IRC §401(g).

would be one-ninth, the third payment would be one-eighth and so on, until the end of the ten-year term. The tenth annual payment would be the remaining vested account balance.

The installment payment election may take a different approach than what is described in the prior paragraph. For example, it might provide for a specific dollar amount (e.g., $10,000 per year) to be distributed, with any remaining balance distributed at the end of the payment term. The election might also provide for a specific dollar amount payment (e.g., $1,000 per month), without a specified installment period. Under this latter method, the payments would continue until the vested account balance is fully distributed.

Using Annuity Contracts to Provide Installment Payments

A defined contribution plan may purchase an annuity contract that will provide the installment payments. When a defined contribution plan purchases an annuity contract with the vested account balance, the installment payments typically will be a uniform amount paid during the installment term under the contract.

Partial Distributions

The above descriptions of the different payment methods assume that the payment method applies to the distribution of the participant's entire vested benefit. A plan might permit a participant to elect to receive only part of his or her benefits from the plan and wait to take the balance at a later time . A partial distribution of benefits is usually elected in the form of a single sum. A single-sum distribution of only a portion of the participant's benefit under a defined contribution plan is determined in the same manner as described above for a lump-sum distribution, except the amount being distributed in a single sum represents only a portion of the participant's vested account balance.

A participant may also be permitted to elect to receive a portion of his or her benefit in an annuity form or installment form, as described above, but such elections are rarely made. When a participant elects a partial distribution, he or she makes no election at that time for the rest of the benefit. How the rest of the benefit is distributed is determined at a later date.

EXAMPLE 8-1. Partial Payment of Vested Interest. A 401(k) plan offers two forms of payment: lump-sum or installment distributions (over a period not longer than the joint life expectancy of the participant and the participant's beneficiary). The plan also permits employees to elect to take a withdrawal if they experienced a personal financial hardship. Hardship withdrawals are always made in a single sum and the payment may not exceed the amount of the hardship need.

Harriet has a vested account balance of $67,000. She qualifies for a hardship withdrawal in the amount of $5,000. A single sum payment of $5,000 is made from the plan to satisfy the hardship need. Harriet's hardship withdrawal election does not affect the future payment of the remaining $62,000 in her vested account balance (nor the distribution of future accumulations in that account balance).

Effect of Minimum Distribution Rules

Once a participant reaches age 70½, there are minimum distribution requirements under IRC §401(a)(9) that may apply. For many participants, minimum distributions are not required until after retirement if the participant retires after age 70½. Any form of payment described above must not violate these minimum distribution requirements. Required minimum distributions are discussed in detail below.

Distribution of Benefits Affected by Valuation Method

Under a defined contribution plan, the timing of benefit distributions to a participant is directly affected by the plan's valuation method, including the frequency with which the plan values account balances. This can lead to some fiduciary issues regarding valuation dates and changes in valuation procedures.

QUALIFIED JOINT AND SURVIVOR ANNUITY

A plan is required to provide a qualified joint and survivor annuity (QJSA), unless a specific exemption applies.[3] The specific requirements for meeting the QJSA rules are detailed in IRC §417. If the QJSA rule applies to a participant, then the plan must follow certain procedures in determining how to pay the participant's benefit. Parallel requirements are found in ERISA §205, so these rules are also enforceable under ERISA.

What Is the QJSA?

The QJSA is a joint and survivor annuity that provides a life annuity to the participant and a survivor annuity for the spouse's life following the participant's death. The survivor annuity must be no greater than 100 percent and no less than 50 percent of the annuity paid during the participant's life.[4] A joint and 50 percent survivor annuity would provide the surviving spouse an annuity payment equal to 50 percent of the participant's annuity payment, whereas a joint and 100 percent survivor annuity would provide the surviving spouse the same annuity payment that the participant received.

The plan document must specify the survivor annuity percentage. The plan may provide two or more survivor annuity percentage options (e.g., 50 percent and 100 percent), and let the participant

[3] IRC §401(a)(11).
[4] IRC §417(b).

elect which survivor annuity percentage will apply to the participant's QJSA benefit.[5] In fact, plans that are subject to the QJSA rules are required to provide two joint and survivor annuity forms.[6]

Unmarried Participant Must be Offered Life Annuity

If the participant is not married, the QJSA is simply a life annuity, that is, an annuity for the participant's life.[7]

When is a Participant Deemed to be Married?

The plan terms may provide that a participant is not considered to be married if he or she were not married throughout the period beginning one year prior to the date on which the QJSA rule would apply.[8] Special rules apply, however, if a couple is married for less than one year as of the annuity starting date, but remains married throughout the one-year period beginning on their wedding date.[9]

QJSA under a Defined Contribution Plan

A defined contribution plan will satisfy the QJSA requirement by purchasing a nontransferable annuity contract. The entire vested account balance is used to purchase the QJSA. The level of payment received under the QJSA will depend on the value of the account balance that is used to purchase the annuity, the age of the participant, the age of the participant's spouse, if applicable, and the annuity purchase rates of the insurer that is issuing the contract.

Entire Vested Accrued Benefit Payable in QJSA

If benefits are required to be distributed as a QJSA, all of the benefit must be paid this way, including amounts attributed to employee contributions and rollover contributions.[10] Also, if a plan with a 401(k) arrangement is subject to the QJSA requirement, the account balance attributable to elective deferrals is included, regardless of whether the elective deferrals are contributed on a pre-tax basis, are designated Roth contributions or are catch-up contributions.

If You're Curious …

A participant's benefit may be subject to a security interest for an outstanding participant loan. The benefit may be reduced for the security interest upon default or if repayment of the loan is accelerated when the participant elects distribution. This reduction of the benefit for the security interest does not violate the QJSA requirement.[11] Because the offset of the benefit reduces the amount payable as a QJSA, a spouse must consent, at the time the loan is taken, to the use of the accrued benefit as security.[12] The consent must

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[5] Treas. Reg. §1.401(a)-20, Q&A-16.
[6] IRC §417(g), as added by PPA §1104.
[7] Treas. Reg. §1.401(a)-20, A-25, Franklin v. Thornton, 983 F.2d 939 (9th Cir. 1993).
[8] IRC §401(a)(11)(D).
[9] Treas. Reg. §1.401(a)-20, A-25(b)(2).
[10] Treas. Reg. §1.401(a)-20, Q&A-11, Rev. Rul. 2004-12.
[11] IRC §417(f)(5).
[12] IRC §417(a)(4); Treas. Reg. §1.401(a)-20, A-24.

occur during the 90-day period ending on the date the loan is made. Spousal consent is not required if the QJSA rule does not apply to the participant or if, at the time of the loan, the value of the accrued benefit does not exceed $5,000.

Pursuant to IRC §408(q), qualified plans may permit participants to make IRA contributions to the plan. IRC §408(q)(1) provides that these deemed IRA accounts in a plan are to be treated as IRAs for all purposes of the IRC. Thus, the QJSA rules are not required to be applied to distributions from deemed IRA accounts held by the plan. [13]

The application of the QJSA requirements to rollover contributions is not dependent on the source of that rollover contribution. For example, if a money purchase pension plan receives a rollover contribution from a profit-sharing plan that was exempt from the QJSA rules, subsequent payment of the rollover contribution from the money purchase pension plan is subject to the QJSA rules because the QJSA requirements are always applicable to a money purchase pension plan.

Similarly, qualified plans may accept rollovers from 403(b) plans and governmental 457(b) plans, as well as from IRAs. Even though 403(b) plans are generally not subject to the QJSA rules, and governmental 457(b) plans and IRAs are never subject to the QJSA rules, once a distribution of any of these types of plans is rolled over to a qualified plan that is subject to the QJSA rules, the QJSA requirements will apply to any subsequent distribution of the rollover contribution from the recipient qualified plan.[14]

Below is a summary of how the QJSA rules apply to different contribution sources in a qualified plan that is subject to QJSA rules:

Source	Included in Vested Benefit for Plans Subject to QJSA Rules?
Employer matching contributions	Yes
Employer nonelective contributions	Yes
Pre-tax elective deferrals	Yes
Designated Roth contributions	Yes
Catch-up contributions	Yes
Deemed IRA contributions	No
Rollover contributions from a plan that was subject to QJSA rules	Yes
Rollover contributions from a plan that was not subject to QJSA rules	Yes
Rollover from an IRA	Yes

[13] Treas. Reg. §1.408(q)-1(e)(1).
[14] Rev. Rul. 2004-12.

Plans That Must Provide the QJSA

A pension plan (i.e., a defined benefit plan, money purchase pension plan or target benefit plan) must provide benefits in the form of a QJSA.[15] A profit-sharing plan or stock bonus plan is not required to provide a QJSA if it satisfies the exemption requirements described below. Note that a 401(k) plan is merely a type of profit-sharing plan or stock bonus plan (unless it is maintained as part of a pre-ERISA money purchase plan), so a 401(k) plan is also not required to provide a QJSA if the exemption requirements are satisfied.

Exemption Requirements for Profit-Sharing and Stock Bonus Plans

For a profit-sharing plan or stock bonus plan to be exempt from the QJSA requirements, the requirements described below must be satisfied.[16] Failure to satisfy any one requirement will subject the participant to the QJSA requirements. It is possible that these requirements may be satisfied for some but not all of the participants. In that case, the plan would have to make the QJSA available at least to the participants who do not satisfy the exemption requirements.[17]

Spouse must be death beneficiary of the entire death benefit. This requirement is satisfied if the participant's benefits are payable in full to the surviving spouse unless the spouse has consented to another beneficiary. As part of this requirement, the death benefit must be available to the spouse within a reasonable period following the participant’s death (generally no more than 90 days), and the benefit payable to the spouse must be adjusted for gains or losses occurring after the participant's death.[18]

Life annuity option cannot be elected. This requirement is satisfied if there are no life annuity options in the plan or, if there are, the participant does not elect into the plan’s life annuity distribution options. Generally, if a plan is intended to be exempt from the QJSA rules, no life annuity options are available, so this rule will be satisfied for all participants.

If a participant is otherwise exempt from the QJSA requirement, the QJSA rules do not apply unless the participant actually elects a life annuity option. However, once a life annuity option is elected by the participant, the requirements will thereafter apply to all of the participant's benefits unless a separate accounting is made of the portion of the account balance subject to the life annuity election.[19] On a practical basis, this type of structure is rarely used, because the very existence of annuity options requires that the various notice and waiver rules be followed and it is those rules that most sponsors seek to avoid. As a result, as mentioned above, most plans that are trying to avoid application of the QJSA rules will not provide any annuity distribution options.

Account balance does not include direct transfer from a plan that was subject to QJSA. For payment of the participant’s benefit to be exempt from the QJSA rule, the participant's account balance must not include a direct transfer from another plan that was subject to the QJSA rule. If this condition is not satisfied, and the plan makes a separate accounting of the transferred benefit, the plan may provide that the QJSA rule is limited to just the separate account that contains the

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[15] IRC §401(a)(11)(B)(I) and (ii).
[16] IRC §401(a)(11)(B)(iii).
[17] Treas. Reg. §1.401(a)-20, A-3.
[18] Treas. Reg. §1.401(a)-20, A-3(b).
[19] Treas. Reg. §1.401(a)-20, A-4.

transferred benefit.[20] If there is no separate accounting, then the participant's entire account balance must be subject to the QJSA rule.

A direct transfer described in the prior paragraph includes neither a rollover (including a direct rollover) nor an elective transfer of distributable benefits. The acceptance of a rollover or elective transfer from a plan that is subject to the QJSA rule does not cause the recipient plan to be subject to the QJSA rule with respect to the participant electing the rollover or elective transfer. Why does the IRS distinguish rollovers and elective transfers from other types of transfers? Because one condition to electing a rollover or elective transfer of distributable benefits is that the participant making such election must waive the QJSA benefit and, if the participant is married, the spouse must consent to that waiver. This waiver eliminates the QJSA provisions with respect to the benefits that are rolled over or transferred to the recipient plan. This is often referred to as "purging the QJSA."

Certain elective transfers due to business transactions or employment status changes do not eliminate QJSA protection. A defined contribution plan may offer employees the right to make an elective transfer to another defined contribution plan if, because of a business transaction (e.g., asset or stock sale) or because of a change in employment status, an employee is no longer entitled to additional allocations under the transferor plan.[21] Because these elective transfers are made when the benefits are not otherwise distributable, if the transferee plan does not otherwise provide for the QJSA rules, it must continue to meet these requirements with respect to the transferred benefits.[22]

EXAMPLE 8-2. Merger of QJSA Plan into Non-QJSA Plan. Abe is a participant in a money purchase plan and a profit-sharing plan maintained by his employer. The employer merges the money purchase plan into the profit-sharing plan. At the time of the merger, the profit-sharing plan is exempt from the QJSA rule. None of the money purchase plan participants is given an opportunity to elect distribution from the money purchase plan pursuant to the merger. The QJSA rule must continue with respect to the money purchase assets transferred into the profit-sharing plan in the merger transaction. Abe's profit-sharing plan account balance need not be subject to the QJSA rule merely because of the merger, as long as there is adequate separate accounting of the money purchase assets and the plan limits the QJSA provisions to those assets.

EXAMPLE 8-3. Transfer from QJSA Plan Made by Direct Rollover. Suppose, in **EXAMPLE 8-2**, that the money purchase plan is not merged into the profit-sharing plan. Instead, the plan is terminated and distribution is made available to participants in the plan. Abe elects a lump-sum distribution from the money purchase plan by waiving the QJSA (with his spouse's consent). Abe also

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[20] Treas. Reg. §1.401(a)-20, A-5(b).
[21] Treas. Reg. §1.411(d)-4, Q&A-3(b).
[22] Treas. Reg. §1.411(d)-4, Q&A-3(b)(2).

elects to have the lump-sum distribution directly rolled over to the profit-sharing plan. The rollover of the money purchase account does not cause the profit-sharing plan to fail the QJSA exemption requirement, because the QJSA was purged through Abe's lump-sum election and his spouse's consent.

Therefore, Abe's rollover account in the profit-sharing plan is not subject to the QJSA rule, even though the rollover assets were accrued under the money purchase plan, unless one of the other exemption requirements is not satisfied. This is an example of an elective transfer of distributable benefits, which does not require continuation of the QJSA rules in the transferee plan unless that plan otherwise must comply with the QJSA requirements.

If this transaction had been accomplished through an elective transfer, rather than a direct rollover, the recipient profit-sharing plan would still not have to apply the QJSA rule to the transferred benefits solely because of the elective transfer.

What if Exemption Requirements Do Not Apply to a Profit-Sharing Plan or Stock Bonus Plan?

If the plan does not satisfy the requirements described above, then the QJSA rules apply to the participants in the plan. That means the QJSA must be the only form of benefit available under the plan, or it must be the required payment method unless the waiver and consent requirements are satisfied.

In some cases, the QJSA rule is applicable to some (but not all) of the plan participants. This can happen when a non-pension plan satisfies the exemption requirements for some, but not all, of the participants. For example, a profit-sharing plan might permit life annuity elections, but only the participants who make those elections are subject to the QJSA rule. Or, a profit-sharing plan might have received transfers from another plan that was subject to the QJSA rules, but those transfers were made for only certain participants. In that case, only the participants who have transfers from the other plan would have to be subject to the QJSA rule. But if the profit-sharing plan does not define the surviving spouse as the automatic death beneficiary in the absence of a valid spousal consent to an alternate beneficiary, that affects all of the participants, and the QJSA rule would be applicable to all distributions from the plan.

Summary of Plan Types and How QJSA Rules Apply

Below is a summary of how the QJSA rules apply to different types of plans:

Plan Type	QJSA Rules Apply?
Defined benefit plan	Yes
Money purchase pension plan	Yes
Target benefit plan	Yes
Profit-sharing plan	No, provided exemption requirements are met
Stock bonus plan	No, provided exemption requirements are met

Plan Type	QJSA Rules Apply?
ESOP	No, unless the ESOP is part of a money purchase pension plan
SEP	No
SIMPLE-IRA plan	No
SIMPLE 401(k) plan	No,
457 plan	No
ERISA 403(b) plan	No, provided exemption requirements are met
Non-ERISA 403(b) plan	No

QJSA Form of Payment Is Mandatory

If the QJSA rule applies to a participant, the QJSA form of payment is mandatory unless the participant elects a different form of payment available under the plan. An election by a married participant to take a different form of payment, even if it is only from a portion of the participant's benefit, is not effective unless the participant's spouse also consents to the election.

If the lump sum value of the participant's benefit is $5,000 or less, a lump sum can be paid instead of the QJSA, without obtaining the spouse's consent. Lump sum values of $1,000 or less may be distributed without participant election or spousal consent. Amounts between $1,000 and $5,000 can be paid to a rollover IRA without participant election or spousal consent under certain circumstances.[23]

If a payment begins in the form of a QJSA, the payment and the benefit for the spouse at the time the benefit commences remains as initiated, even if the parties divorce, and even if the participant remarries.[24]

QPSA Death Benefit

For any participant in a plan that is subject to the QJSA rules, or for a participant in a plan described above who is subject to the QJSA rules because the exemption requirements are not satisfied with respect to that participant, a special preretirement death benefit must be offered by the plan if the participant dies before commencing benefit payments. The required death benefit is a qualified preretirement survivor annuity (QPSA), which must be provided to the participant's surviving spouse unless the QPSA is properly waived.

If You're Curious …

Definition of Spouse for QJSA Purposes

[23] IRC §401(a)(31)(B).
[24] Treas. Reg. §1.401(a)-20, A-25(b)(1).

Prior to 2013, only marriages between individuals of the opposite sex were recognized for federal tax – and, therefore, for qualified plan – purposes. On June 26, 2013, the Supreme Court, in U.S. v. Windsor,[25] ruled that §3 of the federal Defense of Marriage Act (DOMA) is unconstitutional. DOMA §3 states:

> *In determining the meaning of any Act of Congress, or of any ruling, regulation, or interpretation of the various administrative bureaus and agencies of the United States, the word 'marriage' means only a legal union between one man and one woman as husband and wife, and the word 'spouse' refers only to a person of the opposite sex who is a husband or a wife.*

Because DOMA §3 has been deemed unconstitutional, qualified plans must treat the relationship of same-sex married couples as a marriage and must treat each party to that marriage as a spouse to maintain the plans' tax-qualified status. Federal laws may not restrict the terms "spouse" and "marriage" to opposite-sex relationships.

The IRS previously ruled that it will look to applicable state law to determine the marital status of individuals.[26] This position has been expanded in rulings that followed the Windsor decision.[27] In particular, if a marriage is performed in a state that recognizes its validity, such marriage will be considered to be valid for Federal law purposes, including retirement plans, regardless of whether the couple resides in a state that recognizes the marriage. This is called the "state of celebration" determination. Similarly, legally performed marriages in foreign countries are recognized for Federal tax purposes. Accordingly, validly married individuals of the same sex will be considered to be spouses for purposes of applying QJSA rules.

8.04: Restrictions on Distribution Events

The plan may make distribution of benefits available only where it is not contrary to the distribution restrictions applicable to that type of plan. The limitations on permitted distributions are greater for pension plans than for non-pension (profit-sharing or stock bonus) plans. The plan

[25] 133 S.Ct. 2675 (2013).
[26] Rev. Rul. 58-66, 1958-1 CB 60 (1/1/58).
[27] Rev. Rul. 2013-17, IRB 2013-38 (9/16/13); Notice 2014-19, IRB 2014-17 (4/21/14).

document determines when distributions are available, so long as the document does not allow for distribution for a reason or at a time that is not permitted by law.

DISTRIBUTION RESTRICTIONS APPLICABLE TO PENSION PLANS

A pension plan is a defined benefit plan, money purchase plan or target benefit plan. A pension plan may provide for distribution upon retirement, termination of employment, disability or death of the participant.[28]

In-Service Withdrawals After Age 62

A pension plan is permitted to allow for in-service distributions to a participant who has reached age 62, even if normal retirement age is later than age 62.

In-Service Withdrawals after Normal Retirement Age

The reference to retirement includes the attainment of normal retirement age (NRA), even if the participant does not actually terminate employment.[29] The IRS routinely approves pension plan documents that provide for in-service withdrawals after the participant reaches NRA. Generally, a participant may not receive a distribution from a pension plan before NRA, unless he or she has terminated employment or attained age 62. For example, pension plans are not permitted to make in-service withdrawals for hardship reasons.

If You're Curious …

Does an NRA have to be reasonable to provide a right to receive in-service withdrawals without violating the pension plan distribution restrictions? For example, if the plan defines NRA as age 45, and then permits employees to take in-service withdrawals after reaching age 45, would the IRS challenge this as a nonretirement distribution in violation of the pension plan distribution restrictions? Treasury regulations require that the NRA be no earlier than the earliest age that is reasonably representative of the typical retirement age for the industry in which the covered workforce is employed.[30] Treasury officials indicate that an NRA of age 62 to age 65 is presumed to be reasonable. An NRA between 55 and 62 will be considered to be reasonable if the plan sponsor has made a good faith determination that such age is reasonably representative of the retirement age in the industry, based on all the relevant facts and circumstances.[31] An NRA before age 55 will be presumed by the IRS to be unreasonable absent a showing that such lower age is reasonably representative of the typical retirement age in the industry. Plans covering substantially public service employees—e.g., police and fire fighters—may use an NRA of age 50 or higher without issue.[32]

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[28] Treas. Reg. §1.401-1(b)(1)(i).
[29] See, for example, PLR 200420030.
[30] Treas. Reg. §1.401(a)-1(b)(2)(i).
[31] Treas. Reg. §1.401(a)-1(b)(2)(iii).
[32] Treas. Reg. §1.401(a)-1(b)(2)(iv).

A pension plan is permitted to pay full benefits when an employee reaches NRA but does not retire.[33]

The right to take in-service withdrawals from a pension plan at NRA does not extend to distributions at early retirement, as defined by the plan. For example, suppose a pension plan provides for an NRA that is the later of the attainment of age 65 or the fifth anniversary of plan participation. However, the plan also offers an early retirement option to a participant who has reached age 55 and has at least 20 years of service. The plan could offer an in-service withdrawal option at the NRA, but not at the early retirement age. To permit in-service withdrawals after age 55 and completion of 20 years of service, the plan could be amended to redefine NRA as the earlier of: (1) attainment of age 65 (or the fifth anniversary of plan participation, if later), or (2) attainment of age 55 and completion of 20 years of service.

Distributions on Account of Plan Termination

If a pension plan terminates, distribution may be made to participants even though they have neither terminated employment nor reached NRA.[34] The right to a distribution from a terminated pension plan is not limited by whether the employer maintains another plan. Compare this to the restrictions for 401(k) arrangements, where the maintenance of an alternative defined contribution plan can prevent distribution of certain benefits under the 401(k) arrangement solely on account of the termination of the plan.

A partial termination, as described in IRC §411(d)(3), is not a distribution event under a pension plan, even though it results in immediate vesting for the affected participants.[35]

Restrictions Continue if Assets Are Transferred to Non-pension Plan

If pension plan assets are transferred to a non-pension plan, the distribution restrictions applicable to a pension plan must continue to apply to the transferred pension assets because the transferred assets retain the character of the transfer or plan.[36] For example, if the assets of a money purchase plan are transferred into a profit-sharing plan, and the profit-sharing plan permits hardship withdrawals before NRA, the transferred money purchase assets cannot be subject to the hardship withdrawal provision. The conversion of a money purchase plan into a profit-sharing plan would be subject to the same requirement.

A rollover, including a direct rollover under IRC §401(a)(31), from a pension plan to a non-pension plan, would not be subject to the pension plan distribution restrictions, because rollovers take on the character of the recipient plan.[37] Elective transfers also do not retain the character of the

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[33] Treas. Reg. §1.401(a)-1(b)(1)(i).
[34] IRC §401(a)(20).
[35] 2001 Q&A-5 at www.abanet.org/jceb/2001/qairs.html.
[36] Rev. Rul. 94-76, 1994-2 C.B. 46.
[37] Rev. Rul. 2004-12.

transferor plan, so that the distribution rights under the transferee plan may be applied to the transferred assets.

DISTRIBUTION RESTRICTIONS APPLICABLE TO NON-PENSION PLANS

Plans that are not pension plans (i.e., non-pension plans), such as profit-sharing plans and stock bonus plans, may provide for distribution after a fixed number of years, the attainment of a stated age, or upon any other stated event, regardless of whether the participant has terminated employment.[38]

Distribution After Fixed Number of Years

The term **fixed number of years** means at least two years.[39] That means the plan may allow the employee to withdraw funds that have accumulated in the plan for a specified period of at least two years.

The fixed number of years limitation (i.e., the two-year rule described in the prior paragraph) applies only if the right to take the withdrawal is based solely on the length of time the withdrawn funds have accumulated. For example, a withdrawal for a stated event, such as hardship, could be available from funds that have accumulated for fewer than two years.

The IRS permits a profit-sharing plan to allow for a withdrawal after a period of at least five years of participation, regardless of whether the withdrawn funds had been accumulated under the plan for at least two years.[40]

Distribution at Attainment of Stated Age

The stated age for an in-service withdrawal may be any age specified by the plan, including an age that is earlier than NRA, regardless of whether the employee has terminated employment. Compare this rule to the one for pension plans, where in-service withdrawals can be permitted only after the participant has reached NRA or age 62.

Distribution at NRA

Because a nonpension plan may provide for distribution upon any stated event, NRA becomes one possible stated event that might trigger the availability of distributions under the plan. As a result, the NRA may be stated as any age, without regard to whether that age coincides with the participant's actual retirement or whether the age is a customary retirement age in the employer’s

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[38] Treas. Reg. §1.401-1(b)(1)(ii).
[39] Rev. Rul. 71-295, 1971-2 C.B. 184.
[40] Rev. Rul. 68-24, 1968-1 C.B. 150.

industry.[41] Compare this to the rule for pension plans, which requires that the NRA be reasonable to permit in-service withdrawals at such time.

Distribution Upon Other Events

Other events upon which a nonpension plan may permit a distribution include:

- termination of employment;
- a specified period of service or participation (e.g., at least ten years of service with the company);
- financial hardship (as defined by the plan);
- disability;
- layoff;
- illness;
- termination of the plan;
- complete discontinuance of employer contributions; or
- change in the participant's employment or plan participation status.

Note that the financial hardship event in a profit-sharing plan or stock bonus plan is not required to comply with the financial hardship rules prescribed by the IRC §401(k) regulations, except with respect to any 401(k) arrangement in that profit-sharing plan or stock bonus plan.

SPECIAL DISTRIBUTION RESTRICTIONS FOR 401(K) ARRANGEMENTS

Elective deferrals that are made under a 401(k) arrangement are not available for distribution under the rules described above. Any distribution events that pertain to elective deferrals must satisfy the restrictions under IRC §401(k)(2) and (10).

The 401(k) distribution restrictions apply to pre-tax elective deferrals and designated Roth contributions. Furthermore, catch-up contributions are elective contributions and, unless a specific exception applies, are subject to the same rules as other elective contributions.

Elective deferrals in a 401(k) plan may be distributed only upon the occurrence of one or more of the following events:

- Employee’s severance from employment;
- Employee’s death;
- Employee’s disability;
- Employee’s attainment of age 59½ (or a later specified age);
- Employee’s financial hardship including the treatment of certain expenses incurred by the employee’s spouse, dependents or beneficiaries;
- Plan termination, but only if the employer does not maintain an alternative defined contribution plan;
- Permissible withdrawal under an eligible automatic contribution arrangement;

[41] Rev. Rul. 80-276, 1980-2 C.B. 131.

- Qualified reservist distribution; or
- Qualified hurricane distributions.

The distribution restrictions described above apply to all elective deferrals, QNECs, QMACs and safe harbor 401(k) contributions. In addition, note that QNECs, QMACs, earnings on elective deferrals and safe harbor 401(k) contributions were not distributable on account of hardship prior to the 2019 plan year.

A distribution related to plan termination must be in the form of a lump-sum distribution.[42] The lump sum must represent the participant's entire vested account balance, but presumably could be paid in the form of a nontransferable annuity contract (e.g., contract purchased to satisfy QJSA election).

Severance From Employment

A **severance from employment** means that the employee is no longer working for the employer that maintains the 401(k) plan, due to either a voluntary or involuntary termination of that employment. If the employer is acquired in an asset transaction (as opposed to a stock sale or merger), any employees who go to work for the buyer are considered to have experienced a severance from employment, even though the employee continues to work in the same job capacity for the acquiring employer. Similarly, employees who work for a subsidiary that is a participating employer in a parent company plan may be eligible for distributions if the subsidiary is sold and ceases to participate in the plan.[43]

If You're Curious …

Severance from Employment in a Business Transaction

The determination of whether a severance from employment has occurred in a business transaction setting depends on whether the business acquisition is an asset sale or a stock sale.

In an asset sale (i.e., the selling company does not sell its stock, but only assets and liabilities owned by the company), the employees who are transferred to the employment of the purchasing company always have a change of employer. Therefore, a severance from employment with the selling company occurs. In such case, the transferred employees qualify for severance from employment distributions from the selling company's 401(k) plan (subject to the terms of that plan with respect to when distributions may be elected). The only exception to this rule is if, pursuant to the business acquisition, the purchasing company has agreed to continue the seller's plan (or the portion of that plan that covers the transferred employees), either through successor sponsorship or through a spinoff and/or merger of all or a portion of the seller's plan with that of the buyer (or direct trustee-to-trustee transfer, other than by rollover or elective transfer).

[42] IRC §401(k)(10)(B).
[43] Treas. Reg. §1.401(k)-1(d)(2).

If the purchaser intends to take over the seller's plan (or a portion of the seller's plan), that intention should be addressed in the acquisition documents and steps to assume that responsibility (e.g., trustee-to-trustee transfer of the affected account balances from the seller's plan to the buyer's plan, merger of the plans or formal adoption of a separate plan formerly maintained by the seller) should be taken concurrently with the acquisition or as soon as administratively feasible thereafter. In fact, if this is not addressed in the acquisition documents, the employees of the seller who go to work with the buyer will have a claim for distribution from the seller's 401(k) plan on account of severance from employment. This underscores the importance of addressing qualified plan issues in acquisition documents, particularly if the seller does not intend to make distributions available to the employees who are leaving the seller's employment on account of the asset sale.

In a stock sale (or other equity ownership sale, where the company being sold is not a corporation), the employees who work for the company being sold generally do not have a severance from employment, because the identity of their employer has not changed. The only thing that changes on account of the sale is the ownership of the company. Thus, when ownership in a company is sold, the employees who work for the purchased company generally do not qualify for a severance from employment distribution from the purchased company's 401(k) plan. In such case, distribution would be available from that 401(k) plan only if another distribution event has occurred (such as attainment of age 59½, hardship, or termination of the plan).

One situation in which the sale of stock (or other ownership) does result in a severance from employment is where ownership in a subsidiary is sold by the parent company that sponsors a 401(k) plan to a new unrelated parent company. When an ownership interest in a subsidiary is being sold, the subsidiary is leaving one controlled group and going to another controlled group. The IRS treats that as a change of employer for severance from employment purposes because it is viewing the parent-subsidiary relationship as a single employer, consistent with the controlled group rules of IRC §414(b) and (c). A severance from employment applies for plan purposes, however, only if the following condition is met: the plan at issue must continue to be sponsored by the selling parent and neither the purchasing company (i.e., the new parent company of the acquired subsidiary) nor the subsidiary being sold may be a sponsor of the plan after the sale is complete. This condition is not met if the sold subsidiary continues to be a participating employer in the selling parent's plan after the sale or if the accounts of employees of the former subsidiary are transferred or merged into the buyer's plan or a new plan sponsored by the former subsidiary. In other words, the former subsidiary must cease to be a participating employer before the sale is complete, and the only means by which the participants' accounts may end up in the buyer's plan is by distribution and/or rollover to such plan.

The Treasury has concluded that a change of status from being a common law employee to being a leased employee, where the recipient organization of the leased employee's services is the same organization that previously employed him or her as a common law employee, is not a severance from employment.[44] The Treasury based this conclusion on the fact that, pursuant to IRC §414(n), the leased employee is treated as the recipient organization's employee for purposes of the qualified plan rules.

[44] See 69 F.R. 78148 (middle column) (December 29, 2004).

Termination of a 401(k) Plan

When a plan terminates, normally all benefits are distributed. However, when a 401(k) plan is terminated, the elective deferrals, QNECs, QMACs and safe harbor contributions may not be distributed on account of the plan's termination if the employer maintains or establishes an alternative defined contribution plan.[45]

The termination date is usually established by board resolution (or similar legal action, such as the consent of the partners, in the case of an employer that is a partnership).[46]

A distribution made on account of the termination of the 401(k) plan is permissible only if it is a lump sum distribution within the meaning of IRC §402(e)(4)(D).[47] Whether a distribution is a lump sum is determined without regard to the triggering event requirements under IRC §402(e)(4)(D)(i) (I), (II), (III) and (IV). A lump sum includes the distribution of an annuity contract (e.g., to provide a qualified joint and survivor annuity).[48]

Alternative Defined Contribution Plan Defined

An alternative defined contribution plan is any defined contribution plan that exists at any time during the period beginning on the date of the 401(k) plan's termination and ending 12 months after distribution of all the 401(k) plan's assets.[49] The plan is not an alternative defined contribution plan unless it is maintained by the same employer that maintained the terminated 401(k) plan. The following plan types are not alternative defined contribution plans regardless of their sponsorship by the same company that sponsors the 401(k) plan: ESOPs, SEPs, SIMPLE IRAs, 403(b) plans and 457 plans.[50] Note that a SIMPLE-401(k) plan is not exempted and is an alternative defined contribution plan.

Exception if less than 2 percent covered in other plan. If, during the 24-month period beginning 12 months prior to the termination date, less than 2 percent of the eligible employees under the terminating 401(k) arrangement are eligible under another plan, the other plan is not an alternative defined contribution plan. The eligible employees are determined as of the termination date of the 401(k) plan.[51] The alternative defined contribution plan rule is intended to retain elective contributions in a plan in which the 401(k) participants are also participating, if at all possible. However, if no one (or very few participants) in the 401(k) plan will participate in another defined contribution plan, that plan is not relevant to the 401(k) participants.

EXAMPLE 8-4. Successor Plan Need Not be a 401(k) Plan. An employer terminates a 401(k) plan. The employer maintains a money purchase plan. The money purchase plan is an alternative defined contribution plan, even though it does not (and cannot) include a 401(k) arrangement. Because there is an alternative defined contribution plan, the

[45] IRC §401(k)(10)(A).
[46] See, for example, PLR 199931047, where the court ruled that the effective date of a 401(k) plan's termination was determined by the corporate board of directors' resolution.
[47] IRC §401(k)(10)(B).
[48] Treas. Reg. §1.401(k)-1(d)(4)(ii).
[49] Treas. Reg. §1.401(k)-1(d)(4).
[50] Treas. Reg. §1.401(k)-1(d)(4)(ii).
[51] Id.

elective contributions may not be distributed solely because of the 401(k) plan's termination. The result is the same if the other plan is a profit-sharing plan or a target benefit plan.

EXAMPLE 8-5. Transfer of Employees to Another Eligible Plan. Suppose that Division A is closed down on January 1, 2019. Approximately 40 percent of the Division A employees are transferred to Division B and the rest are laid off. The Division A plan is terminated on September 1, 2019. The transferred employees are immediately eligible to participate in the Division B 401(k) plan.

The Division B plan is an alternative defined contribution plan with respect to the transferred employees because they participated in that plan during the period between the termination date and the date 12 months after all Division A plan assets were distributed. Distribution to the transferred employees from the terminated 401(k) plan maintained by Division A may not include their account balances attributable to their elective contributions. Of course, the laid-off employees are still eligible for distribution, because they have satisfied an independent reason for distribution (i.e., severance from employment).

EXAMPLE 8-6. Alternative Defined Contribution Plan Rule Applies to Employees who are Not Eligible for the Alternative Defined Contribution Plan. An employer maintains a 401(k) plan covering Division A and Division B. The employer decides it no longer wants to cover Division A in a 401(k) plan, so it terminates the plan. A new 401(k) plan is adopted that covers only Division B. Division B employees represent more than 2 percent of the eligible employees under the terminated Division A plan.

The new plan is an alternate defined contribution plan, even with respect to the Division A employees. The Division A employees may not receive a distribution of their 401(k) balances solely on account of the plan termination.

Options for Elective deferrals if Alternative Defined Contribution Plan Exists

If distribution cannot be made because of the existence of an alternative defined contribution plan, any of the following options are available.

- Transfer the elective deferrals to the alternative defined contribution plan (most commonly used option);
- Leave the elective deferrals in the terminated plan until a proper distribution event o curs, such as severance from employment; or
- Purchase a deferred annuity contract with the elective deferrals that will protect the optional forms of benefit in the plan.

Remember that benefits in the 401(k) plan that are not subject to the distribution restrictions under IRC § 401(k)(10) are permitted to be distributed on account of the plan's termination. For example, the portion of the account balance attributable to the

employer's nonelective contributions (other than QNECs or safe harbor nonelective contributions) and the portion of the account balance attributable to matching contributions (other than QMACs or safe harbor matching contributions) are distributable on account of the plan termination, even if there is an alternative defined contribution plan.

Only QNECs, QMACs and Safe Harbor Contributions Similarly Restricted

The 401(k) plan distribution restrictions described above are required for all elective deferrals, QNECs, QMACs and safe harbor 401(k) contributions. However, these restrictions do not apply to other types of employer contributions or employee contributions, such as profit-sharing contributions, matching contributions and after-tax employee contributions.

In fact, qualified plans that include benefits derived from after-tax employee contributions or rollovers may permit distribution of those benefits at any time specified in the plan, even if the plan is a pension plan or 401(k) plan that is otherwise subject to more restrictive distribution rules. However, these contributions must be accounted for separately from the restricted accounts, such as the elective contributions.[52]

EXAMPLE 8-7. Distribution Restriction Not Applicable to Rollover. A 401(k) plan receives a rollover contribution of the taxable portion of an IRA distribution, pursuant to IRC §408(d)(3). The plan separately accounts for the rollover contribution. The 401(k) distribution restrictions are not applicable to the rollover contribution. The 401(k) plan may permit distributions from the rollover account at any time.

EXAMPLE 8-8. QMACs under 401(k) Plan. Suppose that a 401(k) plan permits distributions of matching contributions and nonelective contributions after attainment of age 50. However, in the prior year, a portion of the matching contributions has been used to help the elective deferrals pass the ADP test. Matching contributions used for this purpose are QMACs. QMACs are subject to the IRC §401(k) distribution restrictions. Therefore, an age 50 in-service withdrawal option could not apply to the QMACs, but only to a participant's other matching contributions and nonelective contributions.

ESOP Dividends

IRC §404(k) allows a corporation a deduction for dividends paid on employer securities held by an ESOP, so long as certain conditions are met. One of those conditions is that the dividend be paid to the participant (either directly by the corporation or from the ESOP), unless the participant elects to have the dividend reinvested or the dividend is used by the ESOP itself to repay an exempt

[52] Rev. Rul. 2004-12.

loan. The payment of the dividend to the participant from the ESOP is not a restricted distribution, even if the dividends are paid on employer securities purchased with elective contributions under a 401(k) arrangement.[53] But the availability of an ESOP distribution option may affect a participant's ability to take hardship withdrawals under a 401(k) plan.

Distributions Pursuant to a QDRO

The plan may be directed to make a withdrawal to a participant's alternate payee (usually the spouse) by a qualified domestic relations order (QDRO) (discussed later in the chapter). A plan may permit payments to be made to alternate payees, regardless of withdrawal restrictions that otherwise might apply to the participant. This is true even if the participant is still in service and the plan does not otherwise allow in-service withdrawals. However, if the plan does not so provide, restrictions on the participant's ability to receive a distribution might affect the timing of distribution to the alternate payee under the earliest retirement age rule.[54] (Note that the right of an alternate payee to receive a distribution pursuant to a QDRO is not affected if the alternate payee happens to be employed by the same employer and also covered by the plan in his or her capacity as a participant. Of course, such individual cannot take a distribution from his or her own account until a normal distribution event occurs.)[55]

Distribution When a Participant Leaves for USERRA-Covered Military Service

Under the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA), participants who are absent for military service are entitled to make-up benefits.[56] When the serviceperson returns to employment, he or she is entitled to non-seniority-based rights and benefits for the time during the military leave. These rights and benefits are determined as if the service member is on furlough or leave of absence during the military service period.[57] This treatment of the participant as on furlough or leave of absence is solely for purposes of determining the USERRA rights and benefits described above. The participant may actually be treated as having terminated employment for other purposes, such as determining whether he or she has the right to receive distributions from the retirement plan that covers the service member while he or she is a civilian, so long as the individual is on active duty for a period of more than 30 days.[58]

If the plan is not a pension plan, it may provide for the absence due to military service as a stated event for distribution, even if the employee is not treated as terminated from employment during such period. Of course, to the extent the nonpension plan includes a 401(k) arrangement, any portion of the participant's account that is restricted by the 401(k) distribution restrictions (e.g., the elective contributions) would not be able to be distributed merely because of the military

[53] See Q&A-7 of Notice 2002-2.
[54] IRC §414(p)(4)(B).
[55] Q&A-30 in session with the Taxation section of the American Bar Association on May 9, 2003.
[56] 38 U.S.C. Chapter 43 (§§4301-4333), IRC §414(u).
[57] USERRA §4316 and Prop. Reg. §1002.149.
[58] IRC §414(u)(12)(B)(i).

absence, unless the participant is treated as terminated from employment or another acceptable distribution event (e.g., hardship) has occurred.

FINANCIAL HARDSHIP

The 401(k) regulations contain rules for determining when a financial hardship withdrawal is available from the employee's elective deferrals. These strict rules do not apply for distributions of other contributions, such as employer nonelective contributions (other than QNECs and 401(k) and 401(m) safe harbor contributions prior to the 2019 plan year) and employer matching contributions (other than QMACs prior to the 2019 plan year). As previously stated, QNECs, QMACs, earnings on elective deferrals and safe harbor contributions were not distributable on account of hardship prior to the 2019 plan year.

The plan sponsor has significant latitude in determining what constitutes a hardship withdrawal for these other accounts unless the plan document specifically applies the 401(k)-type hardship rules to these other accounts.

Definition of Hardship

The plan must define a hardship in objective terms. The withdrawal must meet two requirements:

- it must be made on account of an immediate and heavy financial need, and
- it must be necessary to satisfy the financial need.[59]

A catch-all definition of hardship that includes any event the administrator deems to be a hardship would be improper administrator discretion and is impermissible.[60] However, the plan may allow the administrator to determine whether a need represents a hardship if the plan sets forth objective criteria for determining what a hardship is.[61]

There are two ways in which a plan may determine whether a participant has met each of the two above requirements. The plan may use a facts-and-circumstances analysis, under which the plan administrator reviews the hardship need and the participant's ability to meet that need, and then makes a determination whether the requirement has been met. Alternatively, the IRC and regulations outline safe harbor standards that may be used to have the requirement deemed to have been met.

Immediate and Heavy Financial Need

Facts-and-circumstances analysis. The regulations indicate that certain needs are, per se, not appropriate for a hardship withdrawal. In particular, the regulations note that the purchase of a boat or a television would not constitute a need for which a plan administrator using the facts-and-circumstances analysis should approve a hardship withdrawal. On the other hand, the regulations

[59] Treas. Reg. §1.401(k)-1(d)(3).
[60] Treas. Reg. §1.411(d)-4.
[61] Treas. Reg. §1.411(d)-4, Q&A-6.

do note that a need does not need to be unforeseeable or involuntarily incurred to qualify for a hardship withdrawal.[62]

Deemed or safe harbor definition of immediate and heavy financial need. Prior to 2019 a withdrawal is deemed to be for an immediate and heavy financial need if it is made for any one or combination of the following reasons:[63]

- medical care for the participant, the participant's spouse, the participant's dependents or the participant's primary beneficiary;
- costs directly related to the purchase of a principal residence (not including mortgage payments) for the participant. This requires that the residence be purchased—a renovation or remodeling is not a sufficient reason for this requirement. Furthermore, the residence may not be for a family member or for a second or vacation home, but must be the primary residence of the participant;
- payments for tuition, related educational fees and room and board expenses, for the next 12 months of post-secondary education (interpreted informally to mean any education for which a high school degree is required) for the participant, the participant's spouse, the participant's children, the participant's dependents or the participant's primary beneficiary;
- payments necessary to prevent eviction from the participant's principal residence, or to prevent foreclosure on the mortgage on that residence;
- payments for burial or funeral expenses for the participant's deceased parent, spouse, children, dependents or the participant's primary beneficiary; or
- expenses for the repair of damage to the participant's principal residence that would qualify for the casualty deduction under IRC §165 (determined without regard to whether the loss exceeds 10 percent of adjusted gross income).

Hardship distributions for medical, tuition and funeral expenses incurred by the participant's primary beneficiary were added by PPA and apply to distributions made in plan years beginning in 2007 or later. A primary beneficiary is an individual who is named as a beneficiary under the plan and has an unconditional right to all or a portion of the participant's account balance upon the participant's death.[64]

This safe harbor definition for an immediate and heavy financial need may be used even if the plan does not use the safe harbor test for determining whether the withdrawal is necessary to satisfy the financial need. Furthermore, it is important not to mix up the phrase "safe harbor" in this context with the other uses of that phrase. For example, whether the safe harbor definition of immediate and heavy financial need is used has nothing to do with whether the plan is a safe harbor 401(k) plan under IRC §401(k)(12) or IRC §401(k)(13). The term "safe harbor" is used throughout the IRC to describe conditions that eliminate or reduce a taxpayer's liability under the law. With regard

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[62] Treas. Reg. §1.401(k)-1(d)(3)(iii)(A).
[63] Treas. Reg. §1.401(k)-1(d)(3)(iii)(B).
[64] PPA §826.

to retirement plans, meeting "safe harbor" requirements frequently grants nondiscriminatory status to a particular plan provision, thus eliminating the need for additional testing.

The following changes are effective as of January 1, 2020 plan year and were optional for the 2019 plan year:

- The participant's primary beneficiary can qualify for medical, educational or funeral expenses;
- The home casualty reason does not have to be in a federally declared disaster area;
- A new item was added to the list that allows for expenses occurred as a result of certain federally declared disasters (the type Congress has previously given special relief to);
- Suspension of elective deferrals or after-tax contributions is no longer allowed;
- Loans are not required prior to taking a hardship; and
- The "facts and circumstances" analysis is eliminated.

Necessary to Satisfy the Financial Need

Again, this requirement is satisfied either under a facts-and-circumstances test or under a deemed or safe harbor test, as specified in the plan. The safe harbor test may be used even if the plan does not use the safe harbor definition of immediate and heavy financial need. Under either standard, the amount withdrawn for hardship may include amounts necessary to pay federal, state or local income taxes or penalties that are reasonably anticipated to result from the withdrawal.[65] For example, if the participant is under age 59½, the withdrawal might be subject to the 10 percent premature distribution penalty under IRC §72(t). Therefore, the withdrawal amount may be grossed up so that, after payment of taxes and the penalty, the amount remaining is sufficient to satisfy the hardship need.

Facts-and-circumstances analysis [66]

In making the facts and circumstances determination, the employer may rely upon the participant's written representation that the need cannot be reasonably relieved through the following sources:[67]

- Reimbursement or compensation by insurance;
- Liquidation of the participant's assets;
- Cessation of elective deferrals or after tax-employee contributions under the plan;
- Other currently available distributions (including distribution of ESOP dividends under IRC §404(k)) or nontaxable loans from plans maintained by the employer or any other employer; or

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[65] Treas. Reg. §1.401(k)-1(d)(3)(iv)(A).
66 Treas. Reg. §1.401(k)-1(d)(3)(iv)(B).
[67] Treas. Reg. §1.401(k)-1(d)(3)(iv)(C).

The written representation cannot be relied upon if the employer has actual knowledge to the contrary.

A need is not reasonably relieved by one of the actions or resources listed above if such action would increase the amount of the participant's need.[68]

Deemed or safe harbor standard for establishing that the amount is necessary to meet the financial need. The distribution is deemed to be necessary to satisfy the need if all of the requirements reflected below are fulfilled.[69] If this occurs, the need to consider the factors discussed above or to obtain the participant's written representation is eliminated.

- **Amount of the withdrawal.** The withdrawal may not exceed the amount of the financial need, including a gross-up for taxes and penalties that will be paid on the withdrawal.[70]
- **Loans and other withdrawals first (only mandatory prior to 2020).** The participant must have received all currently available distributions (other than hardship withdrawal) and all available nontaxable loans from the 401(k) plan and all other plans maintained by the employer (including a related employer).[71] Effective with the 2019 plan year, the plan need not require that a participant take a loan from the plan prior to being granted a hardship withdrawal. This does not mean that the plan has to have a loan program. However, if the plan has a loan program, the participant must first have exhausted the maximum loan limits available under that program. The reference to nontaxable loans means that the loan would not cause the participant to have tax consequences under IRC §72(p). Through this requirement, the IRS is hoping that financial needs are handled primarily with loans, so that the withdrawn amount can be repaid and be preserved for retirement. A hardship withdrawal would not get repaid.
  The regulations state that a loan should not be treated as reasonably available to satisfy the need if the loan itself would increase the need. As noted earlier in relation to the facts-and-circumstances analysis, this issue often arises when the participant is requesting the hardship withdrawal to purchase a residence, but a loan from the plan could jeopardize the participant's ability to obtain third-party financing for the balance of the purchase. This type of loan is not required.[72]
- **Suspension of elective deferrals.** Prior to the January 1, 2020, the plan (or other legally enforceable agreement) must prohibit the employee from deferring or making elective deferrals to any plan maintained by the employer for at least six months after the hardship withdrawal.[73] This suspension also applies to catch-up contributions.[74] As of January 1, 2020 a plan may not suspend deferrals due to a hardship distribution.[75]

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[68] Treas. Reg. §1.401(k)-1(d)(3)(iv)(D).
[69] Treas. Reg. §1.401(k)-1(d)(3)(iv)(E).
[70] Treas. Reg. §1.401(k)-1(d)(3)(iv)(A).
[71] Treas. Reg. §1.401(k)-1(d)(3)(iv)(E)(1).
[72] Treas. Reg. §1.401(k)-1(d)(3)(iv)(D).
[73] Treas. Reg. §1.401(k)-1(d)(3)(iv)(E)(2).
[74] May 11, 2002, Q&A Session with the ABA's Joint Committee on Employee Benefits.
[75] **Original footnote was:**
Treas. Reg. §1.401(k)-3(c)(6)(v)(B).

8.05 Should there be a Heading 1 here?

Maximum Amount of Elective Deferrals Distributable for Hardship

The distributable amount is limited to the participant's aggregate amount of elective deferrals (and prior to the 2019 plan year, without adjustment for investment gains or losses) as of the date of the withdrawal, reduced by previous hardship withdrawals.[76] For example, suppose a participant's elective deferrals account is currently valued at $34,000. The participant has contributed a total of $26,000 in elective deferrals and has taken no prior hardship withdrawals. The maximum hardship withdrawal is $34,000. The difference between $34,000 and $26,000 is the value of the net earnings on the elective deferrals, which is available for hardship withdrawals as of the 2019 plan year. If the participant had taken prior hardship withdrawals, the $34,000 amount would be reduced by the amount of any prior hardship withdrawals.

Prior to the 2019 plan year, QNECs and QMACs were not permitted to be distributed in a hardship withdrawal. Consistent with the treatment for QNECs and QMACs, the IRS interprets the 401(k) safe harbor rules under IRC §401(k) (12) and the 401(m) safe harbor rules under IRC §401(m)(11) to prohibit the hardship withdrawal of safe harbor 401(k) contributions prior to the 2019 plan year.[77]

However, for the 2019 year and subsequent years QNECs, QMACs and Safe Harbor contributions are eligible for hardship distribution.[78]

Financial Hardship Examples

The following examples illustrate some of the rules described above. Unless otherwise stated, assume the plan in question is using the safe harbor definition of hardship, and is using the safe harbor standards for determining financial need. The examples also assume that the participant has no pre-1989 grandfathered amounts in determining the maximum amount available for hardship withdrawal from elective contributions.

EXAMPLE 8-9. Safe Harbor Rule Used by Plan. In 2020, Rupert is a participant in his employer's 401(k) plan. Rupert is requesting $8,000 to pay for college tuition for his daughter. He has not taken any prior hardship withdrawals. Rupert's account balance consists of the following values:

Elective deferrals including earnings = $14,500 (his “401(k) account”)
Aggregate elective deferrals without regard to earnings = $11,600
The maximum amount distributable for hardship from his 401(k) account in 2020 is $14,500.
Matching contributions = $8,200 (his “matching account”)

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[76] Treas. Reg. §1.401(k)-1(d)(3)(ii).
[77] IRS Notice 98-52, §IV.H.
[78] **Original footnote:**
Treas. Reg. §1.401(k)-1(d)(3)(ii)(B).

Nonelective contributions = $5,750 (his "nonelective account")

The plan has no loan program. Hardship withdrawals are permitted under the plan only from the 401(k) account. The only other distribution options under the plan are for separation from service, death or disability. Rupert is still working for the company.

The withdrawal request of $8,000 does not exceed the maximum amount ($14,500) available from the 401(k) account. The reason for the requested hardship distribution is one of the deemed immediate and heavy financial needs. The hardship withdrawal from his 401(k) account is proper, provided Rupert's elective deferrals do not have to be suspended after the withdrawal.

EXAMPLE 8-10. Grossing Up for Anticipated Taxes. Assume the same facts as in **EXAMPLE 8-9**, except Rupert is requesting an additional amount to cover reasonably anticipated taxes on the withdrawal, so that he will have a net distribution of $8,000 to satisfy the tuition payment. This is permitted because the amount needed for the withdrawal can include anticipated taxes and penalties on the withdrawal. So long as the total amount requested does not exceed the $14,500 ceiling on hardship withdrawals from the 401(k) account, the additional amount to cover taxes is permissible. If Rupert is under age 59½ and would be subject to the 10 percent premature distribution penalty under IRC §72(t), Rupert may want to increase the withdrawal to cover the penalty as well.

EXAMPLE 8-11. Non-hardship Withdrawals Available from Other Accounts. A 401(k) plan has no loan program. A participant can have up to three subaccounts in the plan: the 401(k) account (i.e., elective deferrals, as adjusted for investment earnings and losses), the matching account (i.e., matching contributions, as adjusted for investment earnings and losses), and the nonelective account (i.e., employer nonelective contributions, as adjusted for investment earnings and losses). The plan allows the following distribution options:

- Distribution from any of the accounts after separation from service;
- Distribution on account of hardship (using the safe harbor rules) from the 401(k) account (other than investment earnings), as well as from the matching and nonelective accounts;
- Distribution after reaching age 59½ from any of the accounts; and
- Distribution after ten years of service (regardless of age) from the nonelective account.

Morgan has been an employee with the company for 15 years, but he is only 48 years old. Morgan needs $11,000 for tuition toward a Master's Degree program that he is starting. Because Morgan has at least ten years of service, he is eligible

for distribution from the nonelective account. Under the safe harbor requirements for determining financial need, Morgan must first take the maximum distribution available from that account because it is a distribution available for reasons other than hardship. If that account is worth less than $11,000, the rest could be withdrawn under the plan's hardship withdrawal provisions.

EXAMPLE 8-12. Participant is at Least 59½. Khouri is another participant in the plan described in **EXAMPLE 8-11**. He is age 62. Khouri wants to buy a new sports car for $38,000. His 401(k) account is worth $42,000, but only $24,500 is available for hardship (i.e., the cumulative amount of elective deferrals, less prior hardship withdrawals). Khouri may withdraw the entire amount needed ($38,000) from his 401(k) account even though the reason for the withdrawal would not satisfy the hardship events. Khouri is at least age 59½, so withdrawals from the 401(k) account may be permitted without regard to whether there is a hardship need. Because the plan allows withdrawals from any of the accounts after age 59½, Khouri is entitled to the withdrawal.

PERMISSIBLE WITHDRAWAL OF AUTOMATIC ENROLLMENT DEFERRALS

An EACA may allow an employee to elect to withdraw elective contributions that have been made as a result of the automatic enrollment feature if it is done quickly after the automatic enrollment initially applies to the employee. A permissible withdrawal is a distribution made at the employee's election of all contributions made by automatic enrollment on behalf of the employee, adjusted for earnings.

To make a permissible withdrawal, the employee must make the election no later than 90 days after the date of the first elective contribution made on behalf of the employee under the eligible automatic contribution arrangement. The election must be for a withdrawal of the full amount of the employee's elective contributions made by automatic enrollment. Any earnings on the permissible withdrawal are also distributed, and any matching contributions related to the permissible withdrawal are forfeited, even if they would normally be vested. The purpose of these rules is to permit a participant to "undo" the automatic enrollment soon after it occurs. Therefore, any benefits of that enrollment are forfeited when the election for the permissible withdrawal is made.

PLAN MAY BE MORE RESTRICTIVE IN PERMITTING DISTRIBUTIONS THAN LAW REQUIRES

A plan may be more restrictive in making distributions available than the rules described above would permit. For example, a 401(k) plan is not required to make withdrawals available at age 59½ or upon a financial hardship. Similarly, a profit-sharing plan could restrict distributions to termination of employment, death, or disability. Ultimately, when a distribution is available from a plan is a matter of plan design, so long as the options that are stated in the plan do not run afoul of the distribution restrictions. However, once a distribution event is provided for in the plan, the

law restricts the employer's ability to remove that option (or to modify the conditions for electing distribution under such option). (Notwithstanding the foregoing, the law does permit the elimination of hardship withdrawal options, even with regard to accounts that previously could have been distributed on hardship prior to the elimination).[79]

Not only can a plan be more restrictive than the rules described above would allow, but the plan could be written so that a distribution is not even available until the later of NRA or termination of employment. In other words, there is no statutory requirement that benefits be available for distribution while a participant is still working for the employer, nor that benefits be available within a short period after a participant terminates employment (unless the participant has reached NRA).

8.05: Required Minimum Distributions

The previous sections of this chapter have discussed the availability of distributions in certain circumstances, and the form of those distributions. While Congress was fairly liberal in permitting a plan to be very flexible in the timing and form of distributions to participants, it was nonetheless desirable that a participant or the participant's beneficiary take distribution at some point in time. Therefore, the IRC includes certain requirements under which the participant or beneficiary must take funds out of the plan or risk significant excise taxes. These distributions are required within a certain period following the participant's attainment of age 70½. If a participant dies with funds in the plan, the beneficiary's deadline for distribution varies, depending on the relationship of the beneficiary to the deceased participant.

EXPLANATION OF TERMS USED IN THIS SECTION

There are a number of terms in relation to required minimum distributions that need to be defined. This section discusses these terms.

Required Minimum Distribution (RMD)

The **required minimum distribution** (RMD) is the amount that a participant or beneficiary must remove from the plan in a given year under IRC §401(a)(9).

Required Beginning Date (RBD)

The **required beginning date** (RBD) is the date by which a participant must commence RMDs. If RMDs become payable during the participant's lifetime, the RBD always falls on an April 1st.

Participant

For simplicity, we will refer generally to the participant as the person who must commence minimum distributions by the RBD. This is intended to include participants in qualified plans, IRA

[79] Treas. Reg. §1.411(d)-4, A-2(b)(2)(x).

owners, participants in 403(b) plans and participants in 457 plans. Where the text is specific to participants under a particular type of plan, it will refer to the limited group of participants.

Spouse or Surviving Spouse

The spouse or surviving spouse of a participant is determined under applicable state law.[80]

Distribution Calendar Year

A distribution calendar year is a calendar year for which an RMD is required. Note that the minimum distribution is always calculated for a calendar year period, regardless of the plan's plan year.[81] Normally, the required date by which a distribution for a distribution calendar year is due is the last day of such year. However, the first RMD is due on the RBD and is in relation to the prior year, which is the distribution calendar year. In other words, the first distribution calendar year is the calendar year before the RBD. For example, if the RBD is April 1, 2020, the first distribution calendar year is 2019.

The RBD simply provides an extra three months for making the RMD for that year. The second distribution calendar year for a participant is the calendar year that includes the RBD, and that minimum distribution is due by December 31 of that year. In our example, the second distribution calendar year would be 2020, and the minimum distribution for that year would be due by December 31, 2020. All calendar years thereafter (until the benefit is fully distributed), including years following the participant's death, are distribution calendar years, and the minimum distribution is due by December 31 of each such year.

Different Rule for Participants who Die Before RBD

If a participant dies before the RBD, the first distribution calendar year is generally the calendar year that immediately follows the year of the participant's death, unless a five-year rule is used to satisfy the minimum distribution obligation. This will be discussed in further detail below.

DETERMINING THE RBD

Definition of RBD for Qualified Plans

The definition of RBD is different for participants who are 5 percent owners than for participants who are not 5 percent owners. A 5 percent owner for this purpose is defined under the top-heavy rules: an individual who owns or is deemed to own more than 5 percent of the stock of a corporation or the capital or profits share of a partnership, or all of a sole proprietorship.[82]

Participant who is Not a 5 Percent Owner

For a participant who is not a 5 percent owner, the RBD is defined as the April 1 following the end of the calendar year in which the later of two events occurs:

- the participant reaches age 70½; or

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[80] Treas. Reg. §1.401(a)(9)-8, Q&A-5.
[81] Treas. Reg. §1.401(a)(9)-5, Q&A-1(b).
[82] IRC §416(i)(1)(B)(i).

- the participant retires.[83]

EXAMPLE 8-13. 70½ Reached Before Retirement. Jill is a participant in a 401(k) plan. She is not a 5 percent owner of the company that maintains the plan. Jill reaches age 70½ in 2016. She retires in 2019. The later of her attainment of age 70½ or her retirement occurs in 2019. Her RBD is April 1, 2020.

EXAMPLE 8-14. 70½ Reached After Retirement. John is a participant in a 401(k) plan. He is not a 5 percent owner of the company that maintains the plan. John terminates employment in 2011 at age 62. John will not reach 70½ until 2019. The later of John's retirement or his attainment of age 70½ occurs in 2019. John's RBD is April 1, 2020.

Any participant whose employment terminates in the year he or she reaches age 70½, or in a later year, will have an RMD for that calendar year. If the year of termination also happens to be the first distribution calendar year, that distribution can be postponed to April 1 of the following calendar year. Any distribution taken after the event giving rise to the RMD obligation is considered to be attributable to the RMD (unless and to the extent it exceeds the RMD amount).

Because RMDs cannot be rolled over, the amount being rolled over for someone who is over age 70½ should be scrutinized to ensure that it is actually eligible for rollover (i.e., it does not contain the RMD for that year). For example, suppose that a nonowner participant terminates employment after age 70½. Because such termination invokes the RMD requirement, any payment to that participant must first be considered to be that RMD. Only after the RMD amount has been fully paid can the participant roll over any benefit.

Participant who is a 5 Percent Owner

For a participant who is a 5 percent owner, the RBD is the April 1 following the close of the calendar year in which he or she attains age 70½, regardless of whether he or she retires by the end of that year.[84]

EXAMPLE 8-15. 70½ Reached Before Retirement. In **EXAMPLE 8-13** above, if Jill were a 5 percent owner of the company, her RBD would have been April 1, 2017, which is April 1 following the year (2016) in which she reached age 70½. The fact that she had not retired at that time is irrelevant.

EXAMPLE 8-16. 70½ Reached After Retirement. In **EXAMPLE 8-14** above, if John were a 5 percent owner of the company, his RBD would be the same,

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[83] IRC §401(a)(9)(C) and Treas. Reg. §1.401(a)(9)-2, Q&A-2(a).
[84] IRC §401(a)(9)(C) and Treas. Reg. §1.401(a)(9)-2, Q&A-2(b).

because John retired before reaching age 70½. When a participant retires before age 70½, his RBD is the April 1 following the close of the year in which he reaches age 70½, regardless of whether the participant is a 5 percent owner.

When does an Individual Reach Age 70½?

An individual reaches age 70½ six months after his or her 70th birthday.[85] Ultimately, the year in which age 70½ occurs depends solely on whether the participant's birthday falls within the first six calendar months (January through June) of the year or within the second six calendar months (July through December) of the year.

For an individual born between January 1 and June 30, age 70½ is reached in the same calendar year as the 70th birthday (i.e., 70½ reached on July 1 for a January 1 birthday and on December 30 for a June 30 birthday). For an individual born between July 1 and December 31, age 70½ is reached in the next calendar year (i.e., 70½ reached on the next January 1 for a July 1 birthday and on the next June 30 for a December 31 birthday).

EXAMPLE 8-17. Birthday Falls in First Half of Year. A retired individual's 70th birthday is March 10, 2019. The individual reaches 70½ on September 10, 2019, so the calendar year in which the individual reaches 70½ is 2019 for purposes of applying the RBD definition. This means the RBD will be April 1, 2020.

EXAMPLE 8-18. Birthday Falls in Second Half of Year. A retired individual's 70th birthday is August 5, 2018. The individual reaches 70½ on February 5, 2019, so the calendar year in which the individual reaches 70½ is 2019 for purposes of applying the RBD definition. This means the RBD will be April 1, 2020.

Determining Whether a Participant is a 5 Percent Owner

The 5-percent-owner rule is applied for the plan year ending in the calendar year in which the employee attains age 70½.[86] Under the key employee definition, an individual is a 5 percent owner if he or she owns more than 5 percent of the company (or a related group member).

If You're Curious …

Attribution. To determine whether a participant is a 5 percent owner, the attribution rules under IRC §318 apply. For example, suppose the company employs the mother of the 100 percent owner of the company. By attribution under IRC §318, the owner's

[85] Treas. Reg. §1.401(a)(9)-2, Q&A-3.
[86] IRC §401(a)(9)(C)(ii), Treas. Reg. §1.401(a)(9)-2, Q&A-2(c).

mother is a 5 percent owner.[87] The mother's RBD is April 1 of the year following the year in which she reaches age 70½, even if she continues working for the company.

Related groups. The related group rules under IRC §414(b), (c) and (m) are applicable here, because the key employee test under IRC §416 is applied by treating related group members as a single employer. So, if the employer is part of a controlled group of corporations under IRC §414(b), and a participant is a 5 percent owner with respect to any of the controlled group members, the participant is treated as a 5 percent owner of the employer who maintains the plan, even if the participant has no ownership in that particular employer.[88]

Changes in 5 percent owner status after age 70½. Suppose a participant is a 5 percent owner for the calendar year in which he or she reaches age 70½, but subsequently is no longer a 5 percent owner. If, for the calendar year in which the participant reaches age 70½, the participant is a 5 percent owner, he or she is thereafter treated as a 5 percent owner, even if, at a later date, the participant no longer is a 5 percent owner.[89] Thus, a 5 percent owner may not discontinue minimum distributions merely because, at some point after his or her RBD, the participant sells or transfers his or her ownership interest and is still employed.

Participants who become 5 percent owners after the year in which they reach age 70½. Suppose the converse is true, that a participant is not a 5 percent owner for the calendar year in which he or she reaches age 70½ but, before the calendar year in which he or she retires, the participant's ownership in the employer (including attributed ownership, if any) exceeds 5 percent. Would that mean that minimum distributions start on the next April 1, or is the participant still treated as a non-5 percent owner for purposes of the minimum distribution rules? The Treasury Regulations define a 5 percent owner for purposes of IRC §401(a)(9) as a participant who is a 5 percent owner with respect to the plan year ending in the calendar year in which he or she reaches age 70½. So, regulations continue to treat a person as a 5 percent owner or a non-5 percent owner based on his or her ownership at the time that he or she attains age 70½.[90]

[87] IRC §318(a)(1)(A)(ii).
[88] IRC §416(i)(1)(C).
[89] Treas. Reg. §1.401(a)(9)-2, Q&A-2(c).
[90] Treas. Reg. §1.401(a)(9)-2, Q&A-2(c). See also, PLR 200524032.

When RMDs Must Be Paid to Beneficiaries After the Participant's Death

If the participant dies after beginning to receive RMDs, the payments must continue to the beneficiary.[91]

If the participant dies before reaching his or her RBD, special RMD rules apply. In particular, the time when benefits must be paid to the beneficiary is different than it would have been had the participant survived.

Spousal Beneficiaries

If the sole beneficiary is the participant's spouse, the RBD is the last day of the calendar year in which the participant would have attained age 70½.[92]

Other Individual Beneficiaries

If the beneficiary is an individual other than the participant's spouse, when benefits must begin to be paid depends on how the beneficiary wants to take distribution. If the beneficiary begins taking RMDs by not later than the December 31 of the year following the year of death, the beneficiary may spread the payments over his or her lifetime. If the distributions are not begun by that date, the entire balance of the account must be completely distributed by the last day of the fifth year following the year of death.[93]

Non-individual Beneficiaries

If the beneficiary or one of the beneficiaries is not an individual (e.g., the estate, an institution such as a college or most trusts), the five-year rule described above applies.[94]

CALCULATING MINIMUM DISTRIBUTIONS UNDER THE ACCOUNT BALANCE METHOD

Because the defined contribution plan maintains an account balance for the participant, the minimum distributions are determined with reference to the value of the account. This method of satisfying the RMD requirements is referred to as the Account Balance Method. The regulations provide that the Account Balance Method is the default method for calculating minimum distributions from defined contribution plans (as well as IRAs, 403(b) plans and 457(b) plans). However, these plans may employ the annuity method that is required for defined benefit plans.

Where the QJSA rules under IRC §417 apply, the Account Balance Method might not be available. For distributions to be made in a form other than a QJSA, the spouse must consent to the alternative payment method. So, if the spouse, as of the RBD, refuses to consent to a non-QJSA method of payment, the minimum distribution rules will have to be satisfied under the Annuity Distribution

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[91] Treas. Reg. §1.401(a)(9)-2 Q&A-5.
[92] Treas. Reg. §1.401(a)(9)-3, Q&A-3(b).
[93] Treas. Reg. §1.401(a)(9)-3, Q&A-3(a).
[94] Treas. Reg. §1.401(a)(9)-3, Q&A-1.

Method (i.e., an annuity contract is purchased with the participant's account balance to be the QJSA, commencing no later than the RBD).

Calculation of the Annual Minimum Distribution

Under the Account Balance Method, a minimum distribution is calculated for each distribution calendar year. The amount to distribute for each distribution calendar year is determined under the following equation:

$$\frac{\text{Value of Account Balance}}{\text{Life Expectancy Factor}} = \text{Minimum Distribution}$$

Value of Account Balance

The value of account balance is determined in the calendar year preceding the distribution calendar year. The regulations refer to such year as the valuation calendar year. For example, if the distribution calendar year is 2020, the valuation calendar year is 2019. As the distribution calendar year for the RBD distribution is actually the preceding calendar year, then the valuation calendar year for the first minimum distribution is the second calendar year that precedes the RBD. For example, if the RBD is April 1, 2020, the first distribution calendar year is 2019 and the valuation calendar year is 2018. The value of account balance used for a particular valuation calendar year is the value as of the latest valuation date under the plan for that calendar year.

EXAMPLE 8-19. Calendar Year Plan. Norris' RBD is April 1, 2020. Norris participates in a profit-sharing plan. The plan year is the calendar year. The distribution calendar year for purposes of calculating the minimum distribution due by the RBD is 2019. The valuation year for determining the minimum distribution is 2018, so Norris' account balance as of December 31, 2018, is used to make the first RMD calculation. The value of Norris' account balance as of December 31, 2018, is $90,000. The minimum distribution due by April 1, 2020, is determined by dividing $90,000 by the applicable life expectancy factor.

If You're Curious …

The entire account balance, whether or not vested and whether derived from employer or employee contributions, is included in determining the value of the account balance, except with respect to certain "grandfathered benefits" and with respect to qualified longevity annuity contracts (i.e., special annuities purchased with not more than 25 percent of the participant's account that begin payment at an age after NRA (but not later than age 85). These annuities are designed to help ensure that the participant does not outlive his or her entire benefit).[95] This includes any portion of the account balance attributable to rollover contributions received by the plan, regardless of the source of the

[95] Treas. Reg. §1.401(a)(9)-5, Q&A-8, of the 2002 and 2001 Regulations, and §1.401(a)(9)-1, Q&A F-6, of the 1987 Regulations.

eligible rollover distribution.[96] This also includes any portion of the account balance attributable to a designated Roth account.[97]

Deemed IRA account excluded. Deemed IRA accounts are treated as IRAs for all purposes of the tax code.[98] The minimum distribution rules under IRC §401(a)(9) are applied separately to qualified employer plan accounts and any deemed IRA accounts.[99] Thus, if the deemed IRA account is a traditional IRA, the RMD will need to be calculated separately for that account, as if that account represented a separate IRA maintained by the participant. If the deemed IRA account is a Roth IRA, then no RMD will be due from that account until after the participant's death.

Life Expectancy Factor

Under most cases, the life expectancy factor is the distribution period factor that is applicable to the participant's age for the distribution calendar year. The distribution period factor is provided in a uniform lifetime table set forth in the Regulations.

The applicable factor under the uniform lifetime table is based on the participant's age as attained on the participant's birthday that falls in the distribution calendar year. The distribution period factor applies regardless of who the designated beneficiary is or even whether there is a designated beneficiary.

The designated beneficiary is the individual or individuals or, in some cases, the trust, that is:

a. designated by the participant in a beneficiary election form; or

b. designated by the plan as applying if a participant does not elect his or her beneficiary, or if the participant elects one or more beneficiaries that are neither individuals nor trusts (such as educational institutions or other charities), in which case he or she is considered to have no designated beneficiary for purposes of determining the life expectancy factor.

If the participant's sole designated beneficiary for the entire distribution calendar year is his or her spouse, and that spouse is more than ten years younger than the participant, the life expectancy factor used for determining the RMD is the joint life expectancy factor. This is found in a different uniform table in the regulations.

EXAMPLE 8-20. Older Spouse as Designated Beneficiary. A participant reaches her RBD on April 1, 2020, so the first distribution year is 2019. The participant's designated beneficiary is her husband, who is five years older than she. The participant is age 71 on her birthday falling in 2019. Because the sole designated beneficiary is the spouse, and the spouse is fewer than ten years younger than the participant, the life expectancy factor is determined using the uniform lifetime table.

Excerpt From the Uniform Lifetime Table

[96] Rev. Rul. 2004-12.
[97] Treas. Reg. §1.401(k)-1(f)(3)(i).
[98] IRC §408(q)(1).
[99] Treas. Reg. §1.408(q)-1(e)(2).

Age of Employee	Distribution Period
70	27.4
71	26.5
72	25.6
73	24.7
74	23.8
75	22.9

The life expectancy factor is the distribution period factor for age 71 on the uniform lifetime table (26.5).

The value of account balance, determined as of December 31, 2018, is $90,000. The minimum distribution due by April 1, 2020, is $3,396 ($90,000 / 26.5).

For the next calendar year (2020), the life expectancy factor is the distribution period factor for age 72, which is 25.6. The value of account balance, determined as of December 31, 2019, is divided by 25.6 to arrive at the minimum distribution due by December 31, 2020. This approach continues for each subsequent distribution calendar year until (and including) the calendar year in which the participant dies.

EXAMPLE 8-21. Spouse is More than Ten Years Younger. A participant reaches her RBD on April 1, 2020, so the first distribution calendar year is 2019. The participant's designated beneficiary is her husband, who is 15 years younger than she. The participant is age 71 and the husband is age 56 on their birthdays falling in 2019. Because the sole designated beneficiary is the spouse, and the spouse is more than ten years younger than the participant, the life expectancy factor is the joint life expectancy.

Excerpt From the Uniform Lifetime Table

Joint and Last Survivor			
Table Ages	**54**	**55**	**56**
70	31.8	31.1	30.3
71	31.7	30.9	30.1
72	31.6	30.8	30

The joint life expectancy for ages 71 and 56 is 30.1. The value of account balance, determined as of December 31, 2018, is $145,000. The minimum distribution due by April 1, 2020, is $4,817 ($145,000 / 30.1).

8.06: Qualified Domestic Relations Order

DEFINITIONS

Qualified Domestic Relations Order (QDRO)

A **qualified domestic relations order** (QDRO) is a domestic relations order issued by a court or other state-authorized body that provides for the payment of all or a portion of the participant's benefits to an alternate payee and satisfies the requirements of IRC §414(p) and ERISA §206(d). The QDRO is an exception to the antiassignment rule under IRC §401(a)(13) and ERISA §206(d)(1). Thus, if the plan pays benefits under a domestic relations order that is not a QDRO, the plan has violated the antiassignment rule, resulting in disqualification and possible fiduciary liability under Title I of ERISA.

Alternate Payee

The alternate payee may be a spouse, former spouse, child or other dependent of the participant who is "recognized by a domestic relations order as having a right to receive all or a portion of the benefits payable under the plan with respect to the participant."[100] This language provides the state court (or other state-authorized body) to determine the person(s) who are properly alternate payees under the applicable domestic relations law.

REQUIREMENTS FOR A QDRO

To be a QDRO, a domestic relations order must satisfy certain requirements.

State-Sanctioned Orders Only

The order must be a judgment, decree or order relating to child support, alimony payments or marital property rights, and which is made pursuant to state domestic relations law. The order may also be an approval of a property settlement agreement.[101] State domestic relations law is used to define marital property rights for QDRO purposes.

Identifying Information

The order must include certain identifying information as follows:

- Name and last known mailing address of the participant and the alternate payee covered by the order;
- Name of the plan involved;
- Amount or percentage of the participant's benefits to be paid to the alternate payee;
- Number of payments or the period to which the order applies.[102]

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[100] IRC §414(p)(8).
[101] IRC §414(p)(1)(B).
[102] IRC §414(p)(2).

Impermissible Provisions

There are certain provisions that a QDRO must not contain:

- The order must not require a plan to provide an alternate payee or participant with any type or form of benefit or any option not otherwise provided under the plan;
- The order must not require a plan to provide for increased benefits (determined on the basis of actuarial value);
- The order must not require a plan to pay benefits to an alternate payee that are required to be paid to another alternate payee under another order previously determined to be a QDRO; and
- The order must not require a plan to pay benefits to an alternate payee in the form of a QJSA for the lives of the alternate payee and his or her subsequent spouse.[103]

The order may not require a form of benefit or option that is not authorized by the plan. For example, the order may not require the plan to pay the alternate payee in the form of an immediate lump sum if the payment options in the plan do not otherwise provide for this type of distribution. However, it is permissible for the plan document to permit additional types of forms of benefit or options for alternate payees that are not otherwise provided to participants, or to permit alternate payees to receive a distribution when the participant would not be eligible to do so.[104]

Timeline and Procedures

ERISA requires the plan to establish procedures for determining whether a domestic relations order is a QDRO.[105] These procedures must be set out in writing. The QDRO procedures should address the following issues:

- The actions the plan administrator must take when a domestic relations order is received;
- What the plan administrator must do with the affected benefits when it receives a QDRO;
- Establish procedures to determine the qualified status of a domestic relations order; and
- Establish procedures to administer the distribution of benefits that are awarded to the alternate payee under a QDRO.

The DOL has provided some guidance regarding QDRO procedures in its publication, "QDROs: The Division of Retirement Benefits Through Qualified Domestic Relations Order," available at http://www.dol.gov/ebsa/publications/qdros.html.

Notifications

Upon receipt of a domestic relations order, the plan administrator must promptly notify the participant and each alternate payee of its receipt of the order and provide the participant and each alternate payee a copy of the plan's procedures for determining whether a domestic relations order is a QDRO. If the plan administrator knows that the participant or alternate payee is represented

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[103] ERISA §§ 206(d)(3)(D)(i)-(iii) & 206(d)(3)(E)(i)(III) and IRC §§ 414(p)(3)(A)-(C), 414(p)(4)(A)(iii).
[104] IRC §414(p)(3).
[105] IRC §414(p)(6)/ERISA §206(d)(3)(G).

by legal counsel, copies of the acknowledgment letter (and QDRO procedures) should also be sent to counsel.

Within a reasonable time after receipt of a domestic relations order, the administrator is required to determine whether the order is a QDRO and to promptly notify the participant and each alternate payee of such determination.[106] Pending a determination, the plan must make a separate accounting of the alternate payee's interest.[107]

DISTRIBUTION TIMING AND TAXATION

A QDRO can provide for benefit payments to the alternate payee beginning as early as the earliest retirement age under the plan's provisions, even if the participant has not separated from service or otherwise begun to receive payments from the plan.[108] Earliest retirement age is the earlier of:

- The earliest date when the participant is eligible for a distribution under the plan; or
- The later of the participant's 50th birthday or the earliest date upon which the participant could begin receiving distributions from the plan if the participant separated from service.[109]

In other words, if a distribution is available immediately upon termination, then the QDRO would be payable immediately. A plan may permit payment to the alternate payee immediately upon the approval of the QDRO by the plan administrator, even if a payment to the participant would not be permitted. A QDRO cannot require payment of benefits immediately unless the plan contains this feature or the participant has attained a distributable event.[110]

Distributions to a spouse or former spouse who is an alternate payee under a QDRO are generally includible in the income of the alternate payee. Distributions to an alternate payee other than the spouse or former spouse of the participant are generally includible in the gross income of the participant rather than the alternate payee.[111] QDRO payments are not subject to the 10 percent additional tax on early distributions.[112] A spouse or former spouse alternate payee can roll over distributions received pursuant to a QDRO.[113]

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[106] ERISA §206(d)(3)(G)(i); IRC §414(p)(6)(A).
[107] IRC §414(p)(7) and ERISA §206(d)(3)(H).
[108] IRC §414(p)(4)(A)/ERISA §206(d)(3)(E).
[109] IRC §414(p)(4)(B)/ERISA §206(d)(3)(E)(ii).
[110] Treas. Reg. §1.401(a)-13(g)(3) and PLRs 8743102 and 8744023.
[111] IRC §402(e)(1)(A).
[112] IRC §72(t)(2)(C).
[113] IRC §402(e)(1)(B).

8.07: Review of Key Concepts

- What are the different types of distribution forms available in a qualified plan?
- Describe the special rules applicable to each distribution form.
- When is spousal consent required for a distribution from a defined contribution plan?
- What is a QJSA?
- What types of plans are required to provide a benefit in the form of a QJSA?
- Describe the exemptions that must be satisfied to avoid offering a QJSA in a plan.
- What are the distribution restrictions applicable to pension plans?
- What are the distribution restrictions applicable to nonpension plans, including 401(k) plans?
- What are the hardship withdrawal rules?
- Describe the differences in the hardship withdrawal rules in a profit-sharing plan and a 401(k) plan.
- Who is required to take minimum distributions from a qualified plan?
- When must RMDs begin?
- How is the RMD calculated in a defined contribution plan?
- Define and describe the elements of a QDRO.

8.08: For Practice – True or False

1. Money purchase pension plans require spousal consent on distributions over $5,000 if the distribution is paid in a form other than a QJSA.
2. A hardship withdrawal may be grossed-up for anticipated taxes and penalties that will be paid on the withdrawal.
3. Profit-sharing plans may permit in-service withdrawals prior to NRA.
4. A non-5 percent owner may elect to defer RMDs while still employed.
5. A money purchase pension plan may permit hardship withdrawals on account of financial need.
6. A profit-sharing plan may allow for distributions in the form of installment payments.
7. A QJSA provides a life annuity to the participant and, if the participant is married, a survivor annuity for the spouse.
8. A profit-sharing plan must provide a QJSA option.
9. A QDRO may not require a form of benefit that is not allowed by the plan.
10. The required beginning date for RMDs to the participant may be April 1 or December 31.

8.09: Sample Test Questions

1. All of the following types of contributions may be subject to QJSA requirements EXCEPT:

   A. Rollover contributions
   B. Deemed IRA contributions
   C. Elective deferrals

D. Employer matching contributions
E. Employer nonelective contributions

2. All of the following statements regarding lump-sum distributions are TRUE, EXCEPT:

A. It must be paid to the recipient within one taxable year.
B. It may be made due to the participant's death.
C. It may be rolled over into another qualified plan.
D. It may be made due to the participant's separation from service.
E. It must be paid to the recipient after five years of plan participation.

3. All of the following statements regarding QJSA requirements are TRUE, EXCEPT:

A. A QJSA provides a survivor annuity for an unmarried participant's beneficiary following the participant's death.
B. The remarriage of the surviving spouse does not affect the plan's obligation to pay the QJSA.
C. The QJSA must provide a survivor annuity that is not less than 50 percent of the annuity payable during the joint lives of the participant and spouse.
D. A QJSA provides a life annuity to the participant and a survivor annuity for the life of the spouse.
E. The QJSA does not need to be provided if the lump sum value of a vested benefit is less than $5,000.

4. All of the following satisfy the safe harbor definition for hardship withdrawals from a 401(k) plan, EXCEPT:

A. Medical expenses for the participant
B. Funeral expenses for the participant's mother
C. Mortgage payments due on the participant's primary residence
D. College tuition for the participant's dependent son
E. Expenses to repair damage as a result of a natural disaster to the participant's primary residence

5. Which of the following statements regarding in-service and hardship withdrawals is/are TRUE for as of the 2019 plan year?

I. Safe harbor nonelective contributions may not be distributed from a 401(k) plan on account of hardship.
II. Except in the case of hardship or normal retirement, employer contributions must generally remain in a profit-sharing plan for at least two years before an in-service withdrawal is permitted to a participant who has participated for fewer than five years.
III. Profit-sharing plans are required to have the same restrictions on hardship withdrawals that are applicable to 401(k) plans.

A. I only
B. II only
C. I and III only
D. II and III only

E. I, II and III

6. Based on the following information, determine Participant A's maximum available hardship distribution in the 2019 plan year:

    - The participant's hardship is $9,200 for college tuition, adjusted for taxes due.
    - The participant's 401(k) plan only allows for hardship distributions on elective deferral accounts and, effective in 2019, the associated earnings.
    - The participant is 100 percent vested in all sources.
    - No loans are permitted.

    The participant's account is as follows:

Money Type	Contributions	Earnings	Total
Elective Deferral	$5,600	$750	$6,350
Matching	$2,800	$350	$3,150
Total	$8,400	$1,100	$9,500

A. $5,600
B. $6,350
C. $8,400
D. $9,200
E. $9,500

7. Based on the following information, determine Participant C's required beginning date for RMD purposes:

    - Participant C has never had any ownership in the company.
    - Participant C was born on February 25, 1946.
    - Participant C separates from service on November 5, 2018.

A. April 1, 2017
B. August 25, 2017
C. April 1, 2018
D. December 31, 2018
E. April 1, 2019

8. Based on the following information, determine Participant B's first RMD amount:

    - Participant B's required beginning date is April 1, 2020.
    - Participant B's life expectancy factor is 26.5.

Date	Value of Account Balance
December 31, 2015	$ 45,000
December 31, 2016	$ 60,000
December 31, 2017	$ 75,000
December 31, 2018	$ 90,000
December 31, 2019	$105,000

A. $1,698
B. $2,264
C. $2,830
D. $3,396
E. $3,962

9. All of the following are required elements of a QDRO, EXCEPT:

A. Name of the participant
B. Name of the alternate payee
C. Name of the plan administrator
D. Last known mailing address of the participant
E. Last known mailing address of the alternate payee

10. Which of the following statements regarding QDROs is/are TRUE?

I. QDRO payments are subject to the 10 percent tax on early distributions.
II. QDRO distributions to a spouse or former spouse who is an alternate payee are generally includible in the income of the alternate payee.
III. QDRO distributions to a non-spouse alternate payee are generally includible in the gross income of the participant rather than the alternate payee.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

8.10: Solutions to True or False Questions

1. True.
2. True.
3. True.
4. True.
5. False. Money purchase pension plans may not permit in-service withdrawals, including hardship withdrawals.
6. True.
7. True.
8. False. Defined benefit, money purchase and target benefit pension plans must provide QJSA options. A profit-sharing plan may be exempt from the QJSA requirements.
9. True.
10. False. The required beginning date for RMDs is always April 1. Subsequent RMDs must be paid by December 31.

8.11: Solutions to Sample Test Questions

1. The answer is **B**. Deemed IRA accounts in a qualified plan are treated as IRAs for purposes of the IRC. Therefore, the QJSA requirements do not apply to these accounts.
2. The answer is **E**. No years of plan participation are required for a distribution to be considered to be a lump-sum distribution.
3. The answer is **A**. A QJSA does not provide a survivor annuity for an unmarried participant's beneficiary following the participant's death. If the participant is not married, the QJSA is simply a life annuity for the participant's life.
4. The answer is **C**. The costs associated with the purchase of a primary residence would meet the safe harbor definition for an immediate and heavy financial need, but mortgage payments are not included as part of that safe harbor.
5. The answer is **B**. Safe harbor contributions may be distributed from a 401(k) plan on account of hardship starting in 2019. Profit-sharing plans are not required to have the same restrictions on hardship withdrawals that are applicable to 401(k) plans.
6. The answer is **B**. The participant has a financial need that satisfies one of the safe harbor reasons for hardship (college tuition) of $9,200. However, the plan only allows for hardship distributions on elective contribution accounts and the participant only has elective contributions plus earnings to date totaling $6,350. Therefore, the maximum available for a hardship distribution is $6,350.
7. The answer is **E**. A non-5 percent owner must begin receiving RMDs on the April 1 of the year following the later of age 70½ or retirement. The participant attained age 70½ on August 25, 2017. The participant separated from service on November 5, 2018. The participant's required beginning date is the April 1 of the year following the later of those events, or April 1, 2019.
8. The answer is **D**. Participant B's RBD is April 1, 2020. The distribution calendar year is 2019. The valuation calendar year is 2018. Therefore, the value of the account as of December 31, 2018 is used to determine the RMD amount of $3,396 ($90,000 / 26.5).

9. The answer is **C**. While a QDRO must contain the name of the plan involved, the name of the plan administrator is not a required element.

10. The answer is **D**. QDRO payments are not subject to the 10 percent tax on early distributions.

CHAPTER 9:

TAXATION

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9.01: Key Terms

- 10 percent tax on early distributions
- Balance to the credit
- Basis
- Eligible rollover distribution
- Lump-sum distribution
- Rollover

9.02: Introduction

The primary purpose of a retirement plan is to provide benefits to participants upon retirement, death, disability, termination of employment, attainment of a stated age, or financial hardship. In the last chapter, we discussed the payment of benefits to participants. In this chapter, we discuss how those payments are taxed.

Generally, a participant or beneficiary pays no tax on qualified plan benefits until they are actually distributed, even if they are fully vested and distributable upon the participant's election.

9.03: When Is Income Recognized by the Plan Participants?

CONTRIBUTIONS TO QUALIFIED TRUST ARE EXCLUDED FROM INCOME

One of the primary tax advantages of a qualified plan is that participants do not recognize income when the employer makes contributions to the plan. Elective contributions to a 401(k) plan are treated as employer contributions for tax purposes.[1] The employee does not include pre-tax elective contributions in income, even though the contributions are made to the plan at the employee's election and could have been paid to the participant in cash had no deferral election been made. Pre-tax elective contributions are excludable from gross income up to the dollar limit under IRC §402(g) (1)(A), unless they are permissible under the catch-up limit under IRC §414(v).

A participant may be permitted to designate all or part of his or her elective contributions under a 401(k) plan as designated Roth contributions.[2] Although designated Roth contributions are still treated as elective contributions to the plan, they are not excludable from gross income (i.e., the employee includes in income any salary reduction amount that is a designated Roth contribution). The trade-off is that, upon distribution, both the designated Roth contributions and investment earnings attributable to such contributions would be received tax-free as long as the distribution is a qualified distribution. The Roth alternative offers a choice between paying taxes now or paying them later, with respect to the elective contribution amount, and a choice between deferred taxation or no taxation, with respect to investment earnings on such contributions.

A participant may be permitted to make employee after-tax contributions to the plan. Employee after-tax contributions, other than Roth contributions, are from compensation that employees

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[1] IRC §402(e)(3).
[2] IRC §402A.

cannot exclude from gross income nor take a deduction on their tax return. The advantage of these after-tax contributions is the deferral of taxes on the earnings accrued until distributed.

A qualified plan, 403(b) plan, or governmental 457(b) plan may permit participants to make IRA contributions to the plan.[3]3 If deemed IRA contributions are made through salary reduction, such amounts are still includible in gross income because they are treated as IRA contributions by the participant, not employer contributions to the plan.[4] The participant may be entitled to deduct the IRA contribution pursuant to IRC §219, but that will depend on the applicable deduction rules pertaining to IRAs and will be reflected on the participant's individual income tax return.[5] Special tax rules apply to distributions from deemed IRA accounts.

FICA AND FUTA NOT APPLICABLE TO EMPLOYER CONTRIBUTIONS

Employer contributions to the qualified plan are not subject to FICA and FUTA.[6]

Elective Deferrals Are Subject to FICA/FUTA

Although elective deferrals to a 401(k) plan (including catch-up contributions under IRC §414(v) and designated Roth contributions) are treated as employer contributions, such amounts are subject to FICA and FUTA for the year in which such amounts are deferred into the plan.[7]

Deemed IRA contributions also are subject to FICA and FUTA. If deemed IRA contributions are made through salary reduction, such amounts are subject to FICA and FUTA withholding.

Contributions deferred into a nongovernmental 457(b) plan are also subject to FICA and FUTA, either when related services are rendered or there is no substantial risk of forfeiture to the employees' rights to the benefit.

DISTRIBUTIONS FROM THE PLAN

The distributee recognizes income when amounts are actually distributed from the plan.[8] The participant is not subject to taxation merely because the right to take distribution is currently available to him or her. Qualified plan benefits are taxed on actual distribution, even if the distributee has the right to receive a distribution of his or her benefits as of an earlier date, but elects to postpone payment. In most cases, the distributee is the participant. However, payments might be made to the participant's former spouse under a QDRO or to a participant's beneficiary

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[3] IRC §408(q).
[4] IRC §408(q)(1) and Treas. Reg. §1.408(q)-1(c).
[5] Treas. Reg. §1.408(q)-1(f)(4).
[6] IRC §§3121(a)(5)(A) and 3306(b)(5)(A).
[7] IRC §§3121(v)(1)(A) and 3306(r)(1)(A).
[8] IRC §402(a).

after the participant's death. In those cases, the distributee for tax purposes is the person receiving the payments.

Portion of Distribution Includible in Income

When an amount is paid from the plan, it must be determined what portion of the distribution is includible in income. How much is taxable depends on whether the participant has basis in the plan.[9]

Designated Roth, Employee After-Tax, and Deemed IRA Accounts

If the plan accepts designated Roth, employee after-tax, or deemed IRA contributions, it must separately account for each of those contributions (and earnings attributable to such contributions). Special tax rules apply to distributions from the designated Roth, employee after-tax, and deemed IRA accounts.

Postponing Taxation by Rollover

Certain payments from the plan will qualify for rollover treatment. Any amount properly rolled over is not taxable, even though the plan has made a distribution and the amount being distributed would have been includible in income had the rollover not occurred.[10]

Direct Transfer of Assets Not Taxable Event

A direct transfer of a participant's benefits from one qualified plan to another does not, by itself, subject the participant to taxation.[11] A direct transfer might occur without the participant's consent, such as when two plans are merged, or when, pursuant to a business acquisition, the acquiring company's plan accepts a direct transfer of account balances or benefit liabilities from the plan of the prior employer. A direct transfer also might be an elective transfer, which occurs only with the participant's consent. An elective transfer, for tax purposes, is really not distinguishable from a direct rollover. However, an elective transfer may include the transfer of after-tax employee contributions.

Deemed Distributions

In limited circumstances, an amount will be subject to current taxation as if it were distributed from the plan, even though benefits are not being distributed. An example of this is a participant loan that is in default.

Type of Tax Treatment

The portion of a plan distribution that is includible in income is usually taxed as ordinary income. The taxable portion of a plan distribution is treated as ordinary income, regardless of the character of the income generated inside the plan. For example, suppose a participant's account balance in a 401(k) plan is liquidated to make a lump-sum distribution. The investments held for the

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[9] IRC §72.
[10] IRC §402(c).
[11] Rev. Rul. 67-213, 1967-2 C.B. 149.

participant's account were sold to satisfy the distribution obligation. The distribution is taxable as ordinary income even though the sale proceeds on the investments held by the plan would have been treated as capital gains income if the investments were held outside of the plan.

There is a special rule for employer securities distributed in-kind from the plan, where the taxation of the net unrealized appreciation in the securities may be postponed until the shares are sold by the participant (or beneficiary), and the proceeds from the sale can be taxed as capital gain.[12]

Additional Income and Excise Taxes

A distribution from the plan may be subject to an additional income tax if the participant is under age 59½. This is known as the 10 percent tax on early distributions, and is imposed by IRC §72(t).

Noncash Distributions

Although distributions from the plan are usually made in cash, the plan may distribute property. As a general rule, property distributed from the plan, sometimes referred to as an in-kind distribution, is treated in the same manner as a cash distribution, using the property's fair market value at the time of distribution to determine the applicable tax consequences.

Withholding

To the extent a distribution is includible in income, federal income tax withholding rules apply under IRC §3405. State income tax withholding rules may apply to a distribution, pursuant to the laws of each state.

No FICA/FUTA on Distributions

Distributions from a qualified plan are not included as wages for purposes of calculating FICA and FUTA taxes.[13] Therefore, employer contributions (other than elective contributions) made on behalf of an employee are never subject to FICA—not when the contribution is made and not when the contribution is distributed as part of the benefit payment from the plan. Elective deferrals under a 401(k) arrangement, on the other hand, are subject to FICA and FUTA when contributed, but not when distributed from the plan.

Self-employed Individual

The distributions from the plan to a participant who is a self-employed individual are not subject to self-employment taxes under IRC §1401, because they do not represent current earnings from the self-employed individual's trade or business.

Distributions to Persons Other Than the Participant

While a participant is still living, the participant usually will receive distributions directly. In fact, payment of the benefits to a person other than the participant is generally prohibited by the anti-assignment rule of IRC §401(a)(13), although there are some limited exceptions. If a distribution

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[12] IRC §402(e)(4).
[13] IRC §3121(a)(5).

is made to a person other than the participant, the distribution is still taxable to the participant, except for distributions made to a spouse or former spouse pursuant to a QDRO.

QDRO

A distribution may be made to the participant's spouse or former spouse pursuant to a QDRO. These distributions are taxed to the spouse or former spouse, not to the participant. On the other hand, distributions to a non-spouse alternate payee (i.e., a child or dependent) are taxed to the participant.

Death of the Participant

Benefits distributed after the death of the participant are taxed to the beneficiaries that receive the benefits.

9.04: Calculating the Taxable Portion of the Distribution

When a distribution is made from the plan, the amount of the distribution that is taxable (i.e., the portion includible in gross income) must be determined. The taxable portion represents the amount that is subject to the applicable income tax withholding requirements and the 10 percent tax on early distributions. When we refer to an amount as taxable or taxed, we mean the amount is includible in the distributee's gross income (unless it is properly rolled over).

The actual tax rate applicable to the distribution will depend on the individual's taxable income for IRC purposes, which is the participant's gross income after appropriate adjustments. The individual income tax rules for computing gross income, adjusted gross income and taxable income are not addressed in this book. Note that throughout most of this chapter, we will refer to the participant as the recipient of the plan distribution, and will describe the tax consequences in the context of the participant. However, most of these rules apply the same way to beneficiaries of the participant who receive distribution of benefits.

GENERAL TAXABILITY ISSUES

All payments from the plan are taxable unless an exception applies.[14] An amount is not taxable if it represents a return of the participant's basis in the plan. An amount also is not taxable (i.e., it is

[14] IRC §72(a).

excludable from gross income) if it is properly rolled over to another plan or to an IRA. Finally, a qualified distribution from a designated Roth account in the plan is not taxable.

10 PERCENT TAX ON EARLY DISTRIBUTIONS

If a taxable distribution is made to a participant before he or she reaches age 59½, a 10 percent tax applies, unless there is a statutory exception.[15] This tax is in addition to applicable income taxes on the distribution.

If You're Curious …

Dividends payable pursuant to IRC §404(k)

IRC §404(k) grants a corporation a deduction for certain dividends paid on employer securities held by an ESOP, if specific requirements are met. Unless a reinvestment election is made or the dividends are used to repay an exempt loan under the ESOP, the dividends are not deductible unless they are paid to the participant within a specific period of time, either directly by the corporation or passed through the ESOP. Deductible dividends paid to a participant under IRC §404(k) are reported on Form 1099-DIV. They are taxed as ordinary income.[16] Because these amounts are reported as dividends, they are not subject to the basis recovery rules under IRC §72, nor are they subject to rollover treatment or the 10 percent tax on early distributions under IRC §72(t).[17]

Income Averaging Election On Certain Lump-Sum Distributions

Individuals born before 1936 may be eligible for a ten-year averaging election and/or capital gains election for lump sum distributions of amounts related to their plan participation before 1974.

9.05: Lump-Sum Distribution

If You're Curious …

Historically, "lump-sum distributions" received favorable tax treatment. Although this phrase generally means that someone gets all their money in one fell swoop, the phrase is a term of art in the IRC. To be a lump-sum distribution, the payment must constitute the balance to the credit of the employee, and it must be made within one taxable year following a proper distribution event.[18]

Balance to the Credit

[15] IRC §72(t).
[16] IRC §1(h)(11)(B)(ii)(III) and the instructions to Form 1099-DIV.
[17] Notice 2002-2, A-7.
[18] IRC §402(e)(4)(D).

The employee's balance to the credit is the entire value of his or her accrued benefit, including amounts that are not includible in income (basis). The balance to the credit is determined at the time the distribution is made. If contributions or trust earnings are allocated to the participant after the distribution, such amounts need not be distributed in the same taxable year for lump-sum distribution purposes.

If the participant has separated from service, the balance to the credit does not include nonvested amounts. If the participant is still employed by the employer, the balance to the credit includes non-vested amounts. Because the nonvested amount will not be paid to the participant, a partially vested participant must have a separation from service before receiving a lump-sum distribution.

Proper Distribution Event

The primary distribution events for a lump-sum distribution are attainment of age 59½ and separation from service. An employee has a separation from service when he or she retires, resigns, or is discharged. The IRS applies the same-desk rule when a company transaction occurs and an employee is acquired in connection with the transaction by a new employer and continues to perform in the same job. In other words, an individual whose employer is acquired but whose responsibilities remain the same is not considered to have experienced a separation from service for purposes of the distribution rules. These special rules do not impact the ability of such a participant to receive a distribution of his or her 401(k) account in such circumstances, if the rules for obtaining such distributions are met.

Payment Within One Taxable Year

The balance to the credit must be paid within one taxable year of the participant. The payment does not have to occur within the same taxable year in which the distribution event occurs. For example, a distribution made when a participant reaches 70½ may qualify as a lump-sum distribution because of the age 59½ distribution event. Once distribution commences following a proper distribution event, the entire balance must be distributed within a single taxable year to be a lump-sum distribution.

The employee must be a participant in the plan for at least five taxable years for the distribution to qualify as a lump-sum distribution. The taxable year in which the lump sum distribution is received does not count toward this five-year requirement. How an employee's years of participation are determined for this purpose is unclear. In private letter rulings, the IRS has used the active participant rules for IRA purposes, as those rules are also based on the taxable years of the individual.

9.06: Rollovers

WHAT IS A ROLLOVER?

A **rollover** is the transfer of a qualified plan distribution (or part of the distribution) to another retirement plan or to an IRA. The purpose of the rollover is to delay the taxation of the amount rolled over. If an individual does not have an immediate need for the plan distribution, the rollover option permits the continued investment of the benefit on a tax-deferred basis. The individual will

not recognize income on the amount rolled over (and the earnings on that amount) until it is later distributed from the recipient plan or IRA.

A rollover option is not available on all distributions. The distribution must satisfy the definition of an eligible rollover distribution.

The individual excludes from gross income any portion of an eligible rollover distribution that is properly rolled over.[19] A rollover can be made by the individual following payment from the plan or directly by the plan trustee.

A qualified plan also may accept a rollover contribution.

DEFINITION OF AN ELIGIBLE ROLLOVER DISTRIBUTION

An **eligible rollover** distribution is any distribution to the participant of all or any portion of his or her benefit, unless it is specifically excluded.[20] A lump-sum payment of the participant's entire interest would always satisfy the definition of an eligible rollover definition [except any portion of the lump-sum payment that represents an amount described in one of the exceptions discussed below, such as an RMD under IRC §401(a)(9)].

IRC §402(c) refers to an employee as the recipient of an eligible rollover distribution. This reference includes a former employee who is receiving payments from the plan. A rollover option is also available to a surviving spouse of a deceased participant,[21] to a spouse or former spouse

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[19] IRC §402(c)(1).
[20] IRC §402(c)(4).
[21] IRC §402(c)(9).

who is receiving payment of the participant's benefits through a QDRO[22] and a nonspouse beneficiary of a deceased participant, but only by direct rollover to an inherited IRA.[23]

Exceptions to Eligible Rollover Distributions

Exception for Certain Periodic Distributions

A payment is not an eligible rollover distribution if it is part of a series of substantially equal payments over the life or life expectancy of the participant, over the joint life or joint life expectancy of the participant and a designated beneficiary or over a period of ten or more years.[24]

The determination of whether payments are substantially equal is made at the time payments begin. The principles of IRC §72(t)(2)(A)(iv), which provide an exception to the 10 percent tax on early distributions for substantially equal payments, apply in making this determination.[25]

A life annuity or QJSA would fall under the substantially equal payments exception, as would installment distributions if the installment term is within one of the described periods (e.g., a fixed term of at least ten years).

If You're Curious …

Change in amount of payments. If there is a change in the amount of payments at a later date, a new determination must be made at that time as to whether the future payments are substantially equal.[26] This determination is made without taking into account payments or the years of payment that elapsed prior to the change.

EXAMPLE 9-1. Discontinuance of Installment Payments. Myrna's vested account balance in a profit-sharing plan is $250,000. She elects an installment distribution over her life expectancy. For four years, she receives substantially equal payments under the election. None of the payments is an eligible rollover distribution. In the fifth year, Myrna elects to discontinue the installment payments and to receive the remaining balance in her account ($190,000). The distribution of the remaining balance is an eligible rollover distribution.

Separate payment in conjunction with a series of payments. An independent payment made before, at the same time or after the series of payments commences is an eligible rollover distribution.[27]

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[22] IRC §402(e)(1).
[23] IRC §402(c)(11).
[24] IRC §402(c)(4)(A).
[25] Treas. Reg. §1.402(c)-2, A-5; see also, Rev. Rul. 2002-62 and in Q&A-12 of Notice 89-25.
[26] Treas. Reg. §1.402(c)-2, A-5(c).
[27] Treas. Reg. §1.402(c)-2, A-6(a).

EXAMPLE 9-2. Partial Lump Sum with Balance in Installments. Sean's vested account balance in a profit-sharing plan is $150,000. Sean elects an immediate distribution of $30,000, and a 20-year installment of the remaining balance. The $30,000 payment is an eligible rollover distribution, whereas the payments under the 20-year installment distribution fall within the exception for substantially equal payments.

Portion of benefits elected in periodic form. A plan might permit an employee to elect a combination of payment methods, e.g., a partial lump sum with the rest paid in installments or as an annuity. In that case, the substantially equal payments rule is applied to the portion that is subject to the periodic payment election to determine if payments under that portion are eligible for rollover. But the partial lump sum payment is an eligible rollover distribution, because it is not part of the series of substantially equal payments, unless it falls into another exception.

EXAMPLE 9-3. Additional Amount Requested During Installment Term. Robyn elects to receive installment payments from her employer's defined contribution plan. The installment term is the joint life expectancy of Robyn and her husband. The life expectancy period was established in the year the payments commenced, and is reduced by a factor of one for each subsequent year. Under her written distribution election, Robyn has the right to request additional withdrawals, but her annual installment payment will be no less than the amount determined by dividing her account balance at the end of the prior year by the remaining joint life expectancy factor.

As of December 31, 2018, Robyn's account balance is $275,000. The remaining joint life expectancy factor is 30.1. For 2019, Robyn's minimum payment amount under her distribution election is $9,136, determined by dividing $275,000 by 30.1. Robyn requests an additional $6,864, so her total payment will be $16,000.

The additional amount ($6,864) is an eligible rollover distribution because it is independent of her series of substantially equal payments. However, she may not roll over any portion of the minimum payment amount ($9,136) calculated under her installment payment distribution election. [Note: In this example, we are assuming that Robyn has not reached her required beginning date under IRC §401(a)(9), so none of the payment is an RMD.]

Final regular payment in a series. The final payment in a series of substantially equal payments would generally not be eligible for rollover, unless that final payment was substantially larger than the prior payments, as described in EXAMPLE 9-1.[28] Also, an additional payment made because of a reasonable administrative delay in starting distributions, or to correct an administrative error, would not be an eligible rollover distribution.[29]

Payment of portion of benefit in a single sum. If a participant is electing a single sum withdrawal of a portion of his or her account balance or accrued benefit, the withdrawal

[28] Treas. Reg. §1.402(c)-2, A-6(b)(3).
[29] 29 Treas. Reg. §1.402(c)-2, A-6(b)(1).

does not fall within the substantially equal installments exception, even if the participant makes a similar withdrawal on an annual basis. It is important to distinguish between a partial withdrawal and a payment under an installment distribution.

With the installment distribution, the participant is electing a stream of payments over a specified period of time. If that stream of payments consists of substantially equal payments over ten or more years, each payment would not be an eligible rollover distribution. But, if the participant elects a specific sum as a withdrawal from his or her account for each of ten years, each distribution is an eligible rollover distribution because the election for any year does not govern the distribution for future years. With an isolated withdrawal, the participant is free to elect a different amount in a future year, or to elect no distribution in a future year. With an installment distribution, the election is specifying payments for each year covered by the installment election.

EXAMPLE 9-4. Separate Elections to Withdraw Similar Amounts. Kareem is a participant in a profit-sharing plan. The plan permits a participant to withdraw all or any portion of his account after he reaches age 55, even if he continues to work for the employer. Kareem is 60. On April 1, 2019, he elects a withdrawal of $6,000 from his account balance. On June 1, 2020, he elects another $6,000 withdrawal from his account balance.

The 2019 and 2020 distributions are eligible rollover distributions. Each distribution is a single-sum payment of his withdrawal election. The 2019 distribution is not covered by the 2019 withdrawal election, but rather is made only after Kareem makes another election. If Kareem were to make a separate withdrawal election to receive $6,000 in each of ten plan years, each distribution would be an eligible rollover distribution, even though Kareem has received equal payments for a period of ten years.

EXAMPLE 9-5. Installment Distributions. Assume in the prior **EXAMPLE 9-4** that Kareem instead elects on April 1, 2019, to receive annual installment payments over a 15-year period. The payment for each year is based on the value of Kareem's vested account balance divided by the remaining installment period. The 2019 distribution equals $6,000 and the 2020 distribution is $7,000. These distributions are not eligible rollover distributions because they are made under his installment election and the installment period is ten or more years. In addition, the method of determining the annual installment payment is consistent with the IRS' interpretation of substantially equal payments.

Usually, when a participant elects only a partial withdrawal of his or her benefit, he or she intends to receive that payment, not to roll over the payment to another plan or IRA. However, besides denoting that this payment could—in the unlikely event that it was desirable—be rolled over, the characterization of the payment as an eligible rollover distribution is still important because of the income tax withholding rules. Eligible rollover distributions are subject to different withholding rules than are other distributions.

Similarly, distributions in the form of substantially equal periodic payments are the type of distributions that a participant typically would not want to roll over anyway. By electing to receive payments over a period of ten or more years, the participant has successfully spread out the taxation of his or her benefits over a significant period of time. The payment method is more in the nature of a retirement distribution. If the participant only wants the funds to be removed from the qualified plan and their tax-sheltered status maintained elsewhere, he or she could elect a single sum payment from the qualified plan, roll over the distribution to an IRA, and then take distributions from the IRA as he or she needs them for retirement purposes.

Exception for Hardship Withdrawals

All hardship withdrawals are ineligible for rollover, regardless of the contribution source.

Whether a distribution is made on account of hardship or for another reason depends on the terms of the plan. If the participant is receiving the distribution pursuant to the plan's hardship withdrawal provision, then this rollover prohibition applies, regardless of whether the participant might be eligible for distribution for another reason.

Exception for RMDs

Once a participant reaches his or her required beginning date (RBD) under IRC §401(a)(9), he or she is subject to annual RMD rules. Any amount required to be distributed under IRC §401(a)(9) is not an eligible rollover distribution.[30]

Payments that exceed the RMD. If the plan distributes more than the RMD, the additional payment is an eligible rollover distribution unless it falls under one of the other exceptions. For example, a lump sum distribution made to a participant in a year in which an RMD is also required will be eligible for rollover, except for the portion needed to satisfy IRC §401(a)(9).

RMDs are satisfied first. Distributions in a year in which the participant is required to receive an RMD are treated as first satisfying the RMD for that year to determine what portion of any distributions in the year is eligible for rollover.[31]

EXAMPLE 9-6. Distribution in Year of RMD. Maggie reaches 70½ in 2017, but does not retire in that year. Because she is not a 5 percent owner, her RBD for RMD purposes is April 1 of the year that follows her retirement. Maggie retires on March 31, 2019, so her RBD is April 1, 200. Although Maggie's first RMD is not due until April 1, 2020, the amount of that RMD is calculated with respect to the year of her retirement (i.e., 2019), which is her first distribution calendar year. The RMD for the first distribution calendar year is $3,711.

Rather than taking only the RMD, Maggie elects a lump-sum distribution from the plan, which is paid on September 15, 2019. The amount of the lump-sum distribution is $98,400, which reflects the actual value of Maggie's account at the

[30] IRC §402(c)(4)(B).
[31] Treas. Reg. §1.402(c)-2, A-7.

time of distribution. Maggie elects a direct rollover to an IRA. The first $3,711 is considered the RMD for 2019, even though it is not due until April 1, 2020. Therefore, that portion of the lump sum is not eligible for rollover. The administrator should pay Maggie $3,711 (less the appropriate withholding, if any) and roll over the remainder ($94,689).

If You're Curious …

Basis recovery rules on RMDs and coordination with rollover treatment. If the participant's distribution consists partly of basis, the basis is assigned first to the RMD to determine how much of the excess distribution is eligible for rollover.[32] This rule minimizes the tax consequences of the portion of the distribution that is ineligible for rollover because it first represents after-tax dollars. Note, however, that to the extent the basis exceeds the RMD amount, that portion of the basis is eligible for rollover.[33]

Failure to take RMD for a calendar year. If an RMD for a calendar year is not made by the end of that year, it is added to the RMD due for the next calendar year to determine the amount that is ineligible for rollover.

EXAMPLE 9-7. Failure to Take RMD for a Year. A participant's RMD for 2019 is $11,500. No distribution is taken for that year. In 2020, the participant receives a single-sum distribution of his entire vested account balance in the plan. The RMD for 2020 (without regard to the 2019 required distribution) is $12,900. The total distribution amount is $192,000. To determine the amount that is not eligible for rollover by reason of the RMD rules, the RMD for 2019 is added to the RMD for 2020. The remainder of the lump sum is eligible for rollover.

Total distribution: $192,000
Less 2018 RMD: ($11,500)
Less 2019 RMD: ($12,900)

Amount eligible for rollover: $167,600

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[32] Treas. Reg. §1.402(c)-2, A-8, and PLR 9840041.
[33] Treas. Reg. §1.402(c)-2, A-7.

Exception for Corrective Distributions

A plan may need to make distributions to correct certain violations of the qualified plan rules. These corrective distributions are not eligible rollover distributions.[34]

Excess deferrals under IRC §402(g) or excess contributions under ADP test. Distributions under a 401(k) arrangement that are made to correct a violation of the IRC §402(g) dollar limit or to correct a violation of the ADP test are not eligible rollover distributions.

Excess aggregate contributions under the ACP test. Distributions under a qualified plan that are made to correct a violation of the ACP test under IRC §401(m)(2) are not eligible rollover distributions.

Exception for Participant Loans

A participant loan (or portion of the loan) may be a deemed distribution because it violates the requirement of IRC §72(p) (e.g., upon default). A deemed distribution under IRC §72(p) is not eligible for rollover.[35] However, a loan offset is an eligible distribution and can be rolled over.[36] A loan offset occurs when the loan is considered to be distributed and is subtracted from the participant’s account. Of course, the logistics of rolling over a loan offset are more complex than a regular rollover, because no money changes hands between the plan and the participant when an offset occurs. However, if the participant transfers personal funds equal to the amount of the offset to an IRA by the due date of the individual's tax filing for the year of the offset (only available in cases of plan termination or employment termination; for others, the 60 day rule applies), then that amount can be a participant rollover of the offset, and the participant will avoid having to pay income taxes on the offset amount. If no rollover of the offset occurs, the offset amount will be subject to withholding in accordance with the eligible rollover rules (although a special provision applies when no cash is actually distributed). This will be discussed below.

Exception for the Cost of Life Insurance

The cost of life insurance (known as P.S. 58 costs) provided to a participant in a given plan year is currently taxable to the participant in that year as if it were a distribution from the plan. These deemed distributions are not eligible rollover distributions because they are not actual distributions of the benefits being taxed.[37]

Exception for Dividends Paid on Employer Securities

An employer may deduct certain dividends that are paid to participants through the plan on employer securities. These dividend payments are not eligible rollover distributions.[38]

Some ESOPs allow participants the option to reinvest the dividends in employer securities. If the reinvestment election satisfies the requirements of IRC §404(k)(2)(A)(iii), the corporation is still entitled to the deduction. Once the dividends are reinvested, they become part of the participant’s

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[34] 34 Treas. Reg. §1.402(c)-2, A-4.
[35] Id.
[36] Treas. Reg. §1.401(a)(31)-1, A-16.
[37] Treas. Reg. §1.402(c)-2, A-4.
[38] Treas. Reg. §1.402(c)-2, A-4, Notice 2002-2, A-2.

account balance.[39] Thus, if a later distribution of the participant's account includes an amount attributable to reinvested dividends, such amount is eligible for rollover if the distribution otherwise satisfies the definition of an eligible rollover distribution.

If You're Curious …

Rollover of Amounts not Includible in Income under Basis Recovery Rules

The after-tax portion of a distribution may be rolled over if certain conditions are met. In particular, the rollover must be:

- directly transferred to another qualified plan that agrees to separately account for amounts so transferred, including separately accounting for the portion of such distribution that represents the nontaxable portion of the distribution;
- rolled over to an IRA (other than a Roth IRA or SIMPLE IRA). This rule enables participants to retain the investment of after-tax employee contributions in tax-deferred investment vehicles; or
- rolled over directly to a Roth IRA.[40]

EXAMPLE 9-8. Rollover of After-tax Employee Contributions. Margaret has an account balance in a 401(k) plan that totals $123,000. During her period of participation in the plan, Margaret made after-tax employee contributions in addition to her elective contributions. These after-tax employee contributions total $11,000. Margaret elects a lump sum distribution from the plan. Margaret may have the entire $123,000 directly rolled to another retirement plan, through a direct rollover or a trustee-to-trustee transfer, or to an IRA. If the recipient plan is a retirement plan, it must agree to separately account for the rollover contribution, including the portion of that contribution that represents the nontaxable amount.

If the recipient plan of the nontaxable portion is another qualified plan, rather than an IRA, it must be rolled over by a direct rollover—that is, a transfer of funds from the distributing plan trustee to the recipient plan trustee, as outlined under the direct rollover rules of IRC §401(a)(31).[41] In **EXAMPLE 9-8**, if a check is made payable to Margaret for the eligible rollover distribution, she would be permitted to roll over the nontaxable portion of that distribution only to an IRA. It is usually impractical for Margaret to accomplish the rollover through means other than a direct rollover because of the income tax withholding rules.

No Requirement that Recipient Plan Accept After-tax Employee Contributions

There is no requirement in the statute that a recipient plan must accept after-tax employee contributions for the plan to be eligible to receive a direct rollover of the nontaxable

[39] Notice 2002-2, A-7.
[40] IRC §402(c)(2), as amended by PPA §822(a); IRC §408A(e), as amended by PPA §824.
[41] IRC §402(c)(2).

portion of an eligible rollover distribution. So long as the recipient plan agrees to separately account for the rollover contribution and the nontaxable portion of that distribution, it may receive the direct rollover.

Although the nontaxable portion of an eligible rollover distribution usually represents after-tax employee contributions, it is possible for basis to be generated through other means. For example, basis is generated when amounts are repaid on a participant loan that was previously includible in income pursuant to IRC §72(p) (e.g., because of a prior default on the loan). Any portion of an eligible rollover distribution that is not includible in gross income is eligible for the rollover rule described above.

Partial Rollovers - Taxability of Retained Portion

If an eligible rollover distribution includes a nontaxable portion, but the entire distribution is not rolled over, the retained portion (i.e., the amount that is not rolled over) is treated first as attributable to the nontaxable portion. Thus, the recipient plan is not treated as accepting after-tax employee contributions unless the amount rolled over exceeds 100 percent of the taxable portion of the eligible rollover distribution.

Distributions of Restorative Payments and Corrective Allocations

In some cases, a participant will receive a supplemental payment from the plan as part of corrective action taken by the employer, a fiduciary, or another person. This might occur because of a correction of a qualification failure, pursuant to the IRS' Employee Plans Compliance Resolution System (EPCRS), or because of a correction of a fiduciary breach (or potential breach), pursuant to the DOL's Voluntary Fiduciary Compliance Program (VFCP). These supplemental payments represent a portion of the participant's accrued benefit that was not paid with the original distribution. Unless the payment falls within another exception described in this section, it is an eligible rollover distribution.

Summary of Rollover Eligibility

Below is a summary of rollover eligibility for different types of distributions:

Form/Type of Payment	Eligible Rollover Distribution?
Lump-sum distribution	Yes
Partial withdrawal paid as a single sum	Yes
Life annuity	No
QJSA	No
Installment payments over less than 10 years	Yes
Installment payments over 10 or more years	No
RMD	No
Hardship withdrawal	No
Corrective distribution	No
Deemed distribution	No
Loan offset	Yes
Single-sum death benefit paid to beneficiary	Yes

9.07: Taxation of Distributions From Designated Roth Contribution Accounts

A plan may permit a participant to designate all or a portion of his or her elective contributions under a 401(k) or 403(b) plan as designated Roth contributions. If the plan accepts designated Roth contributions, it must separately account for those contributions and the earnings attributable to such contributions.[42] The separate account requirement is necessary to properly apply the tax rules to distributions from the designated Roth account.

A distribution from a designated Roth account will be classified as either qualified or nonqualified. A qualified distribution is entirely excluded from income taxation, even to the extent that the distribution is attributable to investment earnings on the designated Roth contributions.[43] For a distribution to be qualified, both of the following conditions must be true:

11. The distribution must be made after the applicable 5-tax-year period; and
12. The distribution must be for a qualified purpose.

APPLICABLE 5-TAX-YEAR PERIOD

The 5-tax-year period begins on the first day of the first taxable year in which the individual made a designated Roth contribution under the plan.[44] A designated Roth contribution is considered to be made for the taxable year in which it is includable in the employee's gross income. Because most individuals use a calendar year for their tax year, the 5-tax-year period usually begins on January 1. The 5-tax-year period is completed when the fifth year after the beginning date has expired.

EXAMPLE 9-9. Five-tax-year Period. Mary's employer adds a designated Roth contribution feature to its 401(k) plan, effective July 1, 2018. Mary elects to start designating her elective contributions as Roth contributions, beginning with the payroll period ending August 15, 2018. Mary's 5-tax-year period begins on January 1, 2018 and ends on December 31, 2022.

The 5-tax-year period does not commence until an employee begins making designated Roth contributions; just having the ability to make such contributions in the plan is not sufficient.

Once the 5-tax-year period begins, it applies for all designated Roth contributions made to that plan. The period does not need to run separately for each contribution or each plan year.

The 5-tax-year period is unique to each qualified plan. If a participant makes designated Roth contributions to Employer A's plan beginning in 2018, and then starts to make designated Roth contributions to Employer B's plan beginning in 2020, the 5-tax-year period for Employer B's plan would begin on January 1, 2020. The only exception to this rule is if the participant makes a

[42] IRC §402A, Treasury Reg. §1.401(k)-1(f)(2).
[43] IRC §402A(d)(1).
[44] IRC §402A(d)(2)(B)(i); Treas. Reg. §1.402A-1, A-4(a).

direct rollover from one qualified plan to another. In that circumstance, the recipient plan will take on the 5-tax-year period from the distributing plan, assuming that such period begins earlier than the period in the recipient plan. If a designated Roth contribution is rolled over using the 60-day rollover rule, there is no tacking of the 5-tax-year period. The 5-tax-year period will begin on the date of the rollover. Similarly, if there is any rollover of Roth money to a Roth IRA, the 5-tax-year period in the Roth IRA will be that of the IRA; there is no tacking of the period from the qualified plan.

EXAMPLE 9-10. Tacking of 5-tax-year Period in Direct Rollover. Penelope is an employee of X Company, which sponsors a 401(k) plan that permits designated Roth contributions. Penelope begins designating her elective contributions as Roth contributions in August of 2019. Her 5-tax-year period begins on January 1, 2019.

In 2021, Penelope quits working for X Company and begins working for Corporation Z. Corporation Z's 401(k) plan also permits designated Roth contributions. Penelope begins making designated Roth contributions to the Corporation Z plan on March 1, 2021, providing her with a January 1, 2021, starting date for her 5-tax-year period in that plan.

On September 1, 2021, the Corporation Z plan receives a direct rollover of Penelope's designated Roth contribution account from the X Company plan. At that time, Penelope's 5-tax-year period is converted to her period under the X Company plan, which began on January 1, 2019. This new period beginning date is used for her entire designated Roth contribution account, even for new contributions made to the Corporation Z plan. Penelope will satisfy her 5-tax-year period requirement on December 31, 2023.

Once the beginning of a 5-tax-year period in a plan has been established, it does not change. Even if all contributions made to a participant's designated Roth contribution account are distributed, amounts contributed to such account thereafter will retain the original 5-tax-year period.[45]

It is the responsibility of the plan administrator of the plan to keep track of when the 5-tax-year period begins.[46]

QUALIFIED EVENT OR PURPOSE

To be a qualified distribution, the distribution must be on account of one of the following events or purposes:

- Distributions made to the participant after he or she attains age 59½;
- Distributions made to a beneficiary after the participant has died; or
- Distributions made on account of disability.[47]

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[45] Treas. Reg. §1.402A-1, A-4(c).
[46] Treas. Reg. §1.402A-2, A-1.
[47] IRC § 402A(d)(2)(A), referring to IRC §408A(d)(2)(A).

For purposes of this section, a disability must meet the requirements of IRC §72(m), which generally requires that a person not be able to engage in any gainful employment.

Taxation of a Qualified Distribution From a Designated Roth Account

If a distribution is made to a participant after the 5-tax-year period has been fulfilled due to a permitted event or purpose, the distribution is a qualified distribution. A qualified distribution from a designated Roth account is completely tax-free. The effect of this is that the contributions made to the designated Roth account, which were taxed at the time they were made, are distributed out as nontaxable basis. Furthermore, the earnings, which have never been taxed in the past, are exempt from taxation at distribution. This is the essence of the advantage of a designated Roth account.

Taxation of a Nonqualified Distribution From a Designated Roth Account

Distributions from a designated Roth account that are not qualified distributions are subject to taxation on the portion of the distribution that is attributable to investment earnings. This is because the portion attributable to contributions was taxed when the contribution was originally made, so it is an "investment in the contract" or "basis." Basis is not taxed at distribution.

The taxation rules of IRC §72 are applied for this purpose. This section contains "basis recovery rules," that discuss how to determine which part of the distribution is the nontaxable basis portion and which part is the taxable portion.[48]

Under these rules, the designated Roth account prior to distribution is examined, and a fraction is developed, under which the numerator is the amount of contributions made to the account, and the denominator is the total value of the account at the point of distribution. This fraction represents the basis recovery ratio. This percentage of the distribution will be nontaxable. The balance will be taxable.

EXAMPLE 9-11. Taxation of Nonqualified Distribution. Walter receives a $12,000 distribution from a designated Roth account. At the time of the distribution, Walter does not meet the qualified event rule, so the distribution is a nonqualified Roth distribution. At the time of the distribution, Walter's total designated Roth account is $23,000; $21,850 of which represents the amount he contributed to the account (i.e., his basis), and $1,150 of which is income. The basis recovery ratio is $21,850/$23,000 or 95%. Therefore, 95% of the distribution ($11,400) is not taxable and the balance ($600) is taxable.

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[48] IRC §402A(d)(4); Treas. Reg. §1.402A-1, A-3.

ROLLOVER OF DISTRIBUTIONS FROM DESIGNATED ROTH ACCOUNTS

A designated Roth account (or any portion thereof) may be rolled over to a Roth IRA or to another designated Roth account under a 401(k) or 403(b) plan.[49] However, if the rollover is to another designated Roth account, the rollover must be made as a direct rollover if it includes amounts that would not be taxable if they were distributed to the participant (i.e., any portion of a qualified Roth distribution or the portion of a nonqualified Roth distribution that represents a recovery of basis).[50]

If a distribution is made directly to the participant, the 60-day rollover rule may be used, but the recipient IRA must be a Roth IRA if the distribution (or a portion thereof) consists of Roth contributions. A rollover of a designated Roth account distribution under the 60-day rule to a designated Roth account in a 401(k) or 403(b) plan may include only the taxable portion of a nonqualified Roth distribution.

If only a portion of a participant's designated Roth account is rolled over, the rolled over amount is treated as attributable first to the income portion of the designated Roth account, then to the basis in the account.[51]

A qualified plan may be a recipient plan of a rollover from a designated Roth account under another qualified plan, but only if the recipient plan otherwise accepts Roth contributions. In other words, the direct rollover of a distribution from a designated Roth account must be made to a 401(k) plan, 403(b) plan or governmental 457(b) plan that contains a Roth contribution feature.[52]

A 401(k) plan that does not permit Roth contributions, a non-401(k) defined contribution plan (e.g., profit-sharing plan) or a defined benefit plan, may not accept a rollover of an amount distributed from a designated Roth account, even if the rollover consists solely of the taxable portion of a nonqualified Roth distribution. This is true even if the ineligible recipient plan would be willing to account for the rollover contribution as a designated Roth contribution.[53]

As discussed earlier, if a Roth account is rolled over into a Roth IRA, there is no tacking of the 5-tax-year period. Therefore, if the Roth IRA is newly created, the 5-tax-year period will begin anew with regard to funds that were taxable at the time of rollover (i.e., the earnings distributed from the qualified plan as a nonqualified distribution). Funds that were nontaxable at the time of rollover (i.e., the contributions to the qualified plan Roth account distributed in a nonqualified distribution or the total account distributed in a qualified distribution) will be basis in the IRA. The fact that the 5-tax-year period begins anew does not cause nontaxable amounts to be subject to tax on a later distribution from the IRA. Only the earnings that accrue in the IRA (or earnings that were

[49] IRC §402A(c)(3).
[50] Treas. Reg. § 1.402A-1, A-5.
[51] Treas. Reg. §1.402A-1, A-5(b).
[52] IRC §402A(e)(1).
[53] Treas. Reg. §1.402A-1, Q&A5(a).

taxable had they not been rolled over) will be subject to taxation on distribution if the 5-tax-year period in the IRA is not met.

If a Roth account is rolled over into an existing Roth IRA, the rollover contribution takes on the character of the Roth IRA. If the five-year requirement has already been met in the recipient Roth IRA, the rolled over Roth 401(k) contributions would be treated as satisfying the five-year requirement as well, even if the requirement had not been met under the 401(k) plan.

ROLLOVERS OF NON-ROTH FUNDS INTO ROTH IRAS (CONVERSIONS)

Eligible rollover distributions of funds that are not designated Roth contributions and the earnings thereon may be directly rolled over into Roth IRAs. If such a rollover is made, the taxable portion of the rollover distribution is includible in gross income, usually in the same year as the when the rollover occurs.

Once in the Roth IRA, the accumulation of earnings on the rollover contribution will be tax-deferred and distributions of such earnings out of the Roth IRA can qualify for tax-free treatment.

IN-PLAN ROLLOVERS (INTERNAL ROTH CONVERSIONS)

The Small Business Jobs Act of 2010 opened up a new Roth provision to 401(k), 403(b), and governmental 457(b) plans that permit designated Roth contributions. Under this provision, which became effective on September 27, 2010, an individual may elect to convert his or her pre-tax accounts – including both pre-tax elective contributions and employer contribution funds – into designated Roth accounts.[54] This is called an "in-plan rollover" to the designated Roth account. It is also referred to as an "internal Roth conversion." If this is done, the participant will pay taxes on the value of the converted accounts in the year in which the conversion is made.

Effective January 1, 2013, non-Roth funds that are not otherwise distributable from the plan may be converted into Roth funds through an internal Roth conversion. Although an internal Roth conversion involves the recharacterization of non-Roth funds into Roth funds generally without removal of the funds from the plan, the transaction is treated as a type of rollover (even if the amounts are not otherwise distributable). However, the participant's distribution rights with respect to the converted funds and the plan's recordkeeping obligations with respect to the

[54] IRC §402A(c)(4).

converted funds will be affected by whether the funds are otherwise nondistributable at the time of conversion.

If otherwise nondistributable funds are converted, the distribution restrictions that applied to such funds (and applicable earnings) before the conversion continue to apply after the conversion.[55]

When a Roth conversion is elected, the taxable portion of the eligible rollover distribution (i.e., the portion of the amount that would have been taxable to the participant had the amount been distributed to the individual) is includible in gross income.[56]

When accounts needed to be distributable to be converted, the IRS issued guidance that enabled the plan to permit a participant to elect an in-service distribution solely for the purpose of making an in-plan Roth rollover. This provision opened up the ability of Roth conversions of funds without really permitting in-service cash distributions to employees.[57] Because these conversions are now permitted with regard to otherwise nondistributable amounts, this type to of provision is no longer needed.

Spousal consent is not required for in-plan rollovers.[58] Because there is no real distribution, no tax withholding or 10 percent premature distribution tax applies (see next section below).[59]

A qualified plan needs to be amended to permit in-plan Roth rollovers by the later of the last day of the plan year in which the amendment is effective.

Plans are not required to permit Internal Roth conversions, even if the plan has a designated Roth contribution feature. Furthermore, a plan may restrict the types of contributions that are eligible for internal Roth conversion and/or the frequency with which in-plan Roth conversions may be made.[60]

If the internal Roth conversion is the first contribution made to a participant's designated Roth account, the 5-tax-year period begins on the first day of the first taxable year in which the participant makes the internal Roth conversion.

The right to make an internal Roth conversion is not a protected optional form of benefit under IRC §411(d)(6). Rather, it is a "right or feature" within the meaning of Treas. Reg. §1.411(d)-4.

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[55] Notice 2013-74, Q&A-3.
[56] IRC §402A(c).
[57] Id., A-4.
[58] Id., A-3(b).
[59] IRC §402A(c)(4)(A)(ii), Notice 2010-84, A-8.
[60] Notice 2013-74, Q&A-6.

An amendment to eliminate or restrict the right to a distribution of funds must satisfy IRC §411(d)(6).

9.08: 10 Percent Tax on Early Distributions

DESCRIPTION OF RULE

The **10 percent tax on early distributions** is an additional tax levied on distributions paid to the participant before he or she attains age 59½.[61] The purpose of the penalty is to encourage the payment of benefits as a means of providing income for retirement and not before. A plan's qualification is not jeopardized merely because the distribution is subject to the penalty tax, unless the distribution occurs prior to the time the plan or the law permits distributions.

ONLY TAXABLE PORTION IS SUBJECT TO PENALTY

Only the amount of the distribution that is includible in income is subject to the penalty. Any amount that is rolled over to another plan or IRA would not be includible in income and, therefore, would not be subject to the penalty.[62]

Similarly, the distribution of nontaxable amounts, such as basis, is not subject to the additional tax.

EXCEPTIONS TO THE 10 PERCENT TAX ON EARLY DISTRIBUTIONS

Not all distributions paid before the participant reaches age 59½ are subject to the additional tax. The primary exceptions are for certain substantially equal payments made after a participant's separation from service and distributions made to participants who separate from service after attaining age 55.

Substantially Equal Payments Following Separation From Service

Substantially equal payments made over the life or life expectancy of the participant, or over the joint lives or joint life expectancy of the participant and a designated beneficiary, would not be subject to the additional tax if paid after the participant's separation from service.[63]

Separation from Service Required

The substantially equal payment exception may be used at any age, provided the participant has separated from service.

Separation from service is not required when payments are made from an IRA. If a participant is in need of payments from the plan, but has not separated from service, the participant might

[61] IRC §72(t).
[62] IRC §72(t)(1).
[63] IRC §72(t)(2)(A)(iv) and (3)(B).

consider rolling over the benefit to an IRA and taking the substantially equal payments from the IRA.

EXAMPLE 9-12. Substantially Equal Payments by Participant Continuing in Service. A profit-sharing plan permits in-service withdrawals after a participant has participated in the plan for at least five years. Jed, age 45, has satisfied the participation requirement. His vested account balance is $100,000. Jed would like to make penalty-free withdrawals from his account, but does not want to separate from service. Jed elects to withdraw his entire vested account balance and to have a direct rollover of the distribution to an IRA. Jed then commences substantially equal payments over his life expectancy from the IRA.

The payments received from the IRA before Jed reaches age 59½ are exempt from the penalty under the substantially equal payments exception. Jed need not separate from service, because the payments are made from an IRA and not his employer's profit-sharing plan. If Jed had taken the payments directly from the plan, the penalty would have applied because Jed has not separated from service.

Minimum Payment Period for Substantially Equal Payments

The participant must receive the substantially equal payments, without modification, until he or she reaches age 59½ or for five years, whichever period is longer. If the payment method is modified or discontinued before the end of the minimum payment period, the participant is liable for the additional tax, plus interest, on all payments received before age 59½.[64] Interest is charged at the same rate as for underpayment of taxes, pursuant to IRC §6621. The make-up penalty is imposed for the participant's tax year in which the modification or discontinuance occurs.

Exception Can Apply to Payments Made After the Modification Even Though Makeup Penalty Applies to Prior Payments

Suppose the modification that is made to the payment method satisfies the requirements for the periodic payment exception. In that case, there is no penalty on the subsequent periodic payments to be made under the modified election, even though makeup penalties are triggered on the prior payments because of the modification.

If You're Curious …

How to Avoid Penalty if Plan Terminates

Suppose the plan terminates after the payments commence but before the end of the minimum payment period. To avoid the make-up penalty liability, the payments could continue through an annuity contract purchased with the participant's remaining benefit. The payments under the contract could not modify the method of calculating the substantially equal payments. Alternatively, the participant could roll over the remaining

[64] IRC §72(t)(4).

benefit, and the recipient plan or IRA could continue the substantially equal payments under the payment method that had commenced.

Age 55 Exception

If the participant separates from service after reaching age 55, payments received from the plan are not subject to the 10 percent tax on early distributions.[65] The IRS has interpreted the age 55 separation requirement to be satisfied if the participant separates from service during the calendar year in which he or she reaches age 55, even if the actual separation date is before his or her 55th birthday.[66] Payments under this exception may be made in any manner. They do not have to satisfy he substantially equal payments rule.

If a participant separates from service before age 55, but waits until age 55 to commence payments, this exception is not applicable. In that case, the payments would have to satisfy another exception, such as the substantially equal payments exception, to avoid the penalty.

EXAMPLE 9-13. Employee Separates After Reaching Age 55. Shanda, age 56, separates from service. She withdraws $5,000 from her account balance in a money purchase plan. The withdrawal does not satisfy the substantially equal payments exception. The withdrawal is subject to ordinary income tax but is not subject to the 10 percent tax on early distributions because Shanda separated from service after reaching age 55.

EXAMPLE 9-14. Separation Before Age 55, But Payment Postponed Until After Age 55. Liam, age 50, separates from service. He postpones distribution from his employer's profit-sharing plan for five years. When he commences payments from the plan, he has reached age 55. The payments do not satisfy the substantially equal payments exception. The penalty applies to Liam's payments received before age 59½ because his separation from service occurred before age 55, and the payments do not satisfy any other exception.

Not Applicable to IRAs

The age 55 exception is not applicable to IRAs.[67]Payments from an IRA would have to satisfy another exception to avoid the penalty.

Disability

Payments made after a participant becomes disabled are not subject to the 10 percent tax on early distributions, regardless of the participant's age or whether the payments are substantially equal.[68]

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[65] IRC §72(t)(2)(A)(v).
[66] IRS Notice 87-13, A-20.
[67] IRC §72(t)(3)(A).
[68] IRC §72(t)(2)(A)(ii).

Disability is defined in IRC §72(m)(7), which generally means that the individual is no longer able to engage in any substantially gainful activity by virtue of a condition that is expected to be of longstanding duration or to result in death.

Medical Expenses

Distributions that do not exceed the amount of the participant's deductible medical payments are exempt from the 10 percent tax on early distributions.[69] The medical payments must be deductible under IRC §213, which means they must be applied to medical expenses that exceed 10 percent of the participant's adjusted gross income for the 2019 tax year (it was 7.5 percent in the 2018 year). The exception for deductible medical expenses may be made in addition to payments that qualify for other exceptions. This exception is available to IRAs.[70]

Death Payments

Payments made after the participant's death are exempt from the 10 percent tax on early distributions.[71] This exemption applies, regardless of the method of payment elected by the beneficiary.

QDRO Payments

Payments made to an alternate payee under a QDRO are also exempt from the 10 percent tax on early distributions.[72] These payments are exempt from the penalty regardless of the method of payment. In other words, the periodic payment distribution method described above does not have to be satisfied by the alternate payee for QDRO payments to be exempt from the penalty, even if such requirement would apply to the participant if he or she were taking distributions.

Corrective Distributions

Distributions made to correct certain IRC violations are not subject to the 10 percent tax on early distributions if made within the correction periods prescribed by the applicable provision. These include:

- Distributions of excess deferrals under IRC §402(g);[73]
- Distributions of excess contributions under IRC §401(k) (relating to the ADP test);[74]
- Distributions of excess aggregate contributions under IRC §401(m) (relating to the ACP test);[75] and
- Distributions of elective contributions to correct an IRC §415 violation, as permitted under Treas. Reg. §1.415-6(b)(6)(iv).[76]

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[69] IRC §72(t)(2)(B).
[70] IRC §72(t)(3)(A).
[71] IRC §72(t)(2)(A)(ii).
[72] IRC §72(t)(2)(C).
[73] Treas. Reg. §1.402(g)-1(e)(8)(I).
[74] Treas. Reg. §1.401(k)-2(b)(2)(vi)(A).
[75] Treas. Reg. §1.401(m)-2(b)(2)(vi)(A).
[76] Rev. Proc. 92-93, 1992-2 C.B. 505.

P.S. 58 Costs

P.S. 58 costs are not subject to the 10 percent tax on early distributions, even though they are taxed to the participant in the year that insurance coverage is provided by the plan.[77]

Exceptions Relating to Employer Securities

Dividend payments on employer securities that are distributed from the plan to the participant are not subject to the 10 percent tax on early distributions.[78] This is because they are taxed as dividends and not as plan distributions.[79]

Some ESOPs allow participants the option to reinvest the dividends in employer securities. If the reinvestment election satisfies the requirements of IRC §404(k)(2)(A)(iii), the corporation is still entitled to the deduction. Once the dividends are reinvested, they become part of the participant's account balance.[80] Thus, if a later distribution of the participant's account includes an amount attributable to reinvested dividends, such amount is subject to the IRC §72(t) penalty, unless an exception applies.

Distributions to Qualified Reservists

A qualified reservist distribution is exempt from the 10 percent tax on early distributions, as added by PPA. A qualified reservist distribution is any distribution to an individual if:

- The distribution is made from an IRA or from amounts attributable to elective contributions under a 401(k) or 403(b) plan;
- The individual, by reason of being a member of a reserve component, was ordered or called to active duty for a period in excess of 179 days or for an indefinite period; and
- The distribution is made during the period beginning on the date of such order or call and ending at the close of the active duty period.

Qualified reservist distributions made after September 11, 2001, are eligible for this relief.

Permissible Withdrawals Under Eligible Automatic Contribution Arrangements (EACAs)

If a 401(k) plan or 403(b) plan includes an automatic enrollment feature that satisfies the definition of an EACA, a permissible withdrawal by an automatically enrolled employee to cash out his or her elective contributions made as a result of automatic enrollment is not subject to the 10 percent

[77] IRS Notice 89-25, Q&A-11.
[78] IRC §72(t)(2)(A)(vi).
[79] See the instructions to Form 1099-DIV and Announcement 85-168.
[80] Notice 2002-2, A-7.

tax on early distributions. Permissible withdrawals are allowed in plan years beginning in 2008 or later.

No Exception for Hardship or Plan Termination

A distribution is not exempt from the penalty merely because it is made for hardship reasons. Nor is a distribution exempt because the distribution is made on account of the plan's termination. IRC §72(t)(2) provides an exclusive list of exceptions. Hardship and plan termination are not listed under the statutory exceptions. A distribution made for hardship reasons or because of plan termination would be exempt from the penalty only if the distribution happens to satisfy one of the exceptions we have described in this section.

No Exception for Involuntary Distributions

A distribution is not exempt from the penalty merely because it is distributed without the participant's consent (e.g., distribution of vested interest that does not exceed $1,000).[81]

Summary of Rules for 10 Percent Tax on Early Distributions

Below is a summary of events, forms of payment or reasons for distribution from qualified plans that are not subject to the 10 percent tax on early distributions and some notable events that do not qualify for the exception:

Event / Type of Payment / Reason for Distribution	10% Tax on Early Distributions?
Substantially equal payments following a separation from service	Exempt
Separation from service after age 55	Exempt
Disability	Exempt
Medical expenses	Exempt
Death of participant	Exempt
QDRO payment to alternate payee	Exempt
Corrective distribution	Exempt
Taxation of P.S. 58 costs	Exempt
Distribution of dividend payments on employer securities	Exempt
Later distribution of reinvested dividend payments on employer securities	Not exempt
Distribution to qualified reservist	Exempt
Permissible withdrawal of elective contributions made to EACA within 90 days of initial automatic enrollment	Exempt
Hardship withdrawal	Not exempt
Distribution solely due to plan termination	Not exempt
Involuntary distribution	Not exempt

[81] See for example, Vorwald v. Commissioner, 73 T.C.M. 1697 (1997).

9.09: Withholding on Plan Distributions and IRS Reporting Requirements

FEDERAL INCOME TAX WITHHOLDING

IRC §3405 contains rules for federal income tax withholding on plan distributions. The method of withholding depends on whether the distribution is an eligible rollover distribution.

If You're Curious …

Responsibility for Withholding

The plan administrator is primarily responsible for withholding.[82] The plan administrator may transfer this responsibility to the payor (e.g., bank trustee) if it directs the payor in writing to withhold the tax, and provides the information necessary to correctly compute the withholding tax liability.[83]

Employer as Agent

The employer can act as agent of the payor in making distributions. For example, a bank trustee may transfer plan funds to the employer, and the employer, in turn, makes the distribution (and deducts the withholding, if applicable). The bank trustee (or the plan administrator, if liability for withholding has not been properly transferred to the payor) would still be liable for the withholding if the employer (acting as agent) fails to comply.[84] Although this arrangement is described in the cited regulation, IRS officials have informally expressed the opinion that such an arrangement is not an appropriate method of making distributions from the plan, and that the agency arrangement is solely for the purpose of transmitting withholding to the IRS.[85]

Deposit of Withholding

Withholding is deposited with a federal tax depository, unless the electronic depositing rules described below apply. Form 8109, Federal Tax Deposit Coupon, must accompany the withholding deposit. See Circular E, an IRS publication, for withholding deposit rules.

Electronic Depositing

IRC §6302(h) requires electronic depositing of withholding by certain taxpayers. The electronic depositing rules are phased in for taxpayers (including qualified plans that have withholding requirements), based on the amount of withholding by the taxpayer.[86] Electronic depositing is done via the Electronic Federal Tax Payment System (EFTPS).

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[82] IRC §3405(d)(2).
[83] Treas. Reg. §35.3405-1, E-2 and E-3.
[84] Treas. Reg. §35.3405-1, A-16.
[85] See for example, A-75 in the IRS' Q&A Session at the 1999 Annual Conference for ASPPA.
[86] Treas. Reg. §§1.6302-1 through 1.6302-3, and Treas. Reg. 31.6302-1.

EFTPS is a free service provided by the Department of Treasury. For more information, you may visit the EFTPS website at www.eftps.gov.[87]

Penalties for Not Making Electronic Deposits

If a taxpayer (including a plan) is subject to the electronic withholding requirement, the IRS will assess the failure to deposit penalty under IRC §6656 if the deposits are not made electronically, even if a timely deposit is made with a paper coupon.

Form 9779 to Enroll for Electronic Depositing

IRS Form 9779 is the enrollment form for electronic depositing. A plan that is not required to use electronic depositing may elect to do so voluntarily.

Withholding on Eligible Rollover Distributions

If a distribution is an eligible rollover distribution, IRC §3405(c) requires 20 percent of the distribution to be withheld for federal income tax purposes, to the extent the distribution is not rolled over in a direct rollover transaction [as described in IRC §401(a)(31)].

Definition of Eligible Rollover Distribution

For this purpose, the phrase, "eligible rollover distribution" has the same meaning as discussed earlier in this chapter.[88] This includes eligible rollover distributions paid from qualified plans, from 403(b) plans, and from governmental 457(b) plans. This does not include distributions from IRAs (including SEPs, SIMPLE IRAs and Roth IRAs) that are eligible for rollover, even if the distribution is eligible for rollover to a qualified plan, 403(b) plan, or governmental 457(b) plan. Although IRA distributions are eligible for rollover, they are not included in the definition of an eligible rollover distribution.

EXAMPLE 9-15. Withholding on Eligible Rollover Distributions that are Not Rolled Over. Constance elects a lump sum distribution from her employer's 401(k) plan. Her total distribution is $45,000. The entire amount constitutes an eligible rollover distribution. Although it is eligible for rollover, Constance does not elect a direct rollover of any part of the distribution. The withholding liability is $9,000 (i.e., 20% x $45,000). Constance will receive a check for $36,000 (assuming no state income tax withholding), even though her taxable distribution is $45,000, because $9,000 of her distribution is transmitted to the IRS for withholding purposes.

[87] IRS Circular E.
[88] IRC §3405(c)(3); see also IRC §402(f)(2)(A).

No Withholding on Distributions of Less than $200

If all distributions to the participant for the calendar year are less than $200, no withholding is required.[89] If the first distribution for the year is less than $200, and it is not known whether other eligible rollover distributions will be made for the year, withholding is not required.

Nontaxable Portion of Distribution Disregarded

The 20 percent withholding tax applies only to the portion of the eligible rollover distribution that is includible in gross income. Therefore, the nontaxable portion of a distribution (i.e., the basis recovery portion) is never subject to the 20 percent withholding tax, even if that amount is not rolled over.

EXAMPLE 9-16. Withholding on Distributions Including Basis. John receives a lump-sum distribution from his employer's qualified plan. The total distribution is $130,000, but $20,000 is the basis recovery portion (i.e., the portion representing John's after-tax employee contributions made to the plan). Therefore, only $110,000 of the distribution is includible in gross income. Only $110,000 of the total eligible rollover distribution is potentially subject to withholding, and only to the extent such amount is not directly rolled over. If John does not directly roll over any portion of that $110,000, the withholding liability is $22,000 (i.e., 20 percent x $110,000).

Partial Rollovers

If only a portion of the amount eligible for rollover is transferred in a direct rollover transaction, only the portion not directly rolled over, to the extent it does not represent a recovery of basis, is subject to the 20 percent withholding tax.[90]

Withholding Rate is Not the Actual Tax Rate

The 20 percent withholding rate does not necessarily correspond to the actual tax rate on the distribution. The actual tax liability will depend on how much other income the participant has. When the participant files his or her individual income tax return, the taxable portion of the distribution is included in income, and the 20 percent withholding amount will be shown as a credit toward the participant's tax liability for that year. Even if the participant expects to owe a tax that is less than 20 percent on the distribution, a lesser withholding rate cannot be elected on a lump-sum distribution.

Withholding on Noncash Distributions

There is no exception from the withholding rules merely because noncash assets are distributed. If the distribution includes noncash assets, the fair market value of the property is used to determine the taxable amount subject to withholding. Withholding must be made from the cash portion of the distribution. If the cash portion is not sufficient, the property (or a portion of the property) may

[89] Treas. Reg. §31.3405(c)-1, A-14.
[90] Treas. Reg. §31.3405(c)-1, A-6.

be sold prior to distribution, and the proceeds used to pay the withholding tax. Alternatively, the participant may remit cash to the plan administrator or pay to satisfy the withholding obligation.[91] The latest valuation of the property may be used to calculate withholding, as long as the plan makes that valuation at least once per year.

EXAMPLE 9-17. Withholding on Distribution Including Noncash Assets. Nelson receives an eligible rollover distribution from a plan, which he does not elect to have directly rolled over. The distribution consists of $20,000 of cash and property valued at $50,000, for a total value of $70,000. Nelson does not have any basis in the plan, so the total amount is includible in income. The withholding obligation is 20% x $70,000, or $14,000. The withholding may be taken from the cash, so that Nelson receives the property plus $6,000 of cash.

EXAMPLE 9-18. Insufficient Cash to Pay Withholding on Distribution. Suppose in the prior EXAMPLE 9-17 that the distribution consists of $20,000 of cash, but the property is worth $100,000, for a total value of $120,000. Now the required withholding is 20% x $120,000, or $24,000. All of the cash can be used to satisfy part of the withholding, but another $4,000 is needed. Nelson may remit $4,000 cash to the payor to satisfy the withholding, or the property (or a portion of the property) can be sold by the plan to generate sufficient cash to pay the required withholding. Alternatively, Nelson may elect a direct rollover of the property and avoid the withholding requirement on it.

Withholding Exceptions for Certain Property and for Certain Cashless Distributions

Special withholding rules apply to distributions of certain noncash or cashless distributions:

- employer securities;
- offsets against the accrued benefit due to a participant loan obligation;
- deemed distributions under IRC §72(p) with respect to participant loans; and
- nontransferable annuity contracts, if no withholding is required because the distribution of the contract is not a taxable event.

In the case of an annuity contract, withholding instead will be taken from the payments made under the annuity contract, generally under the rules described below unless the annuity contract distribution is eligible for rollover (e.g., lump sum paid for surrender of the contract), in which case the withholding rules described above apply.

Special Withholding Rule for RMDs

A required distribution under IRC §401(a)(9) is not subject to the 20 percent mandatory withholding because it is not an eligible rollover distribution. Suppose, however, that the

[91] Treas. Reg. §§31.3405(c)-1, A-10(d), and 35.3405-1, F-1 through F-3.

participant receives a distribution that exceeds the RMD under IRC §401(a)(9). Unless the distribution falls under one of the exceptions to the eligible rollover distribution definition, the excess part of the distribution would be eligible for rollover and would be subject to the 20 percent withholding.

If You're Curious …

The 20 percent withholding on the excess can be avoided, even if the amount is otherwise eligible for rollover, if the RMD is based on a joint life expectancy factor for a participant who has a designated beneficiary. A joint life expectancy factor will produce a smaller RMD than the participant's single life expectancy factor. Under an exception in the regulations, the RMD can be treated by the plan administrator as the amount that would be required if the participant did not have a designated beneficiary to determine whether 20 percent withholding is required on any portion of the distribution.[92]

Application of this Rule

As discussed in Chapter 8, RMDs are determined using a Uniform Lifetime Table.[93] The Uniform Lifetime Table can be used during a participant's lifetime even if the participant does not have a designated beneficiary. The only exception to the use of the Uniform Lifetime Table is when the participant's spouse is the sole designated beneficiary and the spouse is more than ten years younger than the participant, in which case the joint life expectancy factor is used. Thus, the special rule described above would apply only in the case of a participant whose designated beneficiary is a spouse who is more than ten years younger than the participant.

EXAMPLE 9-19. RMD under Joint Lifetimes when Spouse is More than Ten Years Younger than Participant. Carol, age 72, is married to Warren, age 55. Carol is a participant in a defined contribution plan and is required to take a minimum distribution for the current calendar year. The plan simplifies calculations for RMD purposes by making all determinations on the basis of the Uniform Lifetime Table, even if the participant's spouse is more than ten years younger. Under the Uniform Lifetime Table, the applicable factor is 25.6. The joint life expectancy factor that applies to Carol and Warren (ages 72 and 55) is 30.8. The relevant account balance for calculating the RMD is $200,000.

Had the plan used the joint life expectancy factor, Carol's RMD would be $6,494 (i.e., $200,000/30.8). However, the plan distributes $7,813, based on the Uniform Lifetime Table factor (i.e., $200,000/25.6). The amount distributed exceeds the actual amount required under IRC §401(a)(9). Nonetheless, the withholding rules are applied as if that excess amount is part of the RMD. Therefore, the mandatory withholding rules that are used for eligible rollover distributions do not apply to the entire amount.

The same result would hold true if, instead of the plan automatically calculating the RMD in this manner, Carol requests a distribution in excess of $6,494. In that case, the plan

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[92] Treas. Reg. §31.3405(c)-1, A-10(c).
[93] Treas. Reg. §1.401(a)(9)-9.

administrator could apply this special withholding rule to a requested distribution of up to $7,813 (i.e., the amount determined using the Uniform Lifetime Table). However, the withholding requirements for any amount distributed in excess of $7,813 would depend on whether that additional amount is an eligible rollover distribution. For example, if Carol requests $9,000, $7,813 could be treated as the RMD amount for withholding purposes and the remainder would be subject to 20 percent withholding or to voluntary withholding, depending on whether it is an eligible rollover distribution.

Withholding on Distributions That Are Not Eligible Rollover Distributions

If the distribution is not an eligible rollover distribution, a different set of withholding rules apply. First, the rate of withholding is different. The withholding rate depends on whether the distribution is a periodic payment or a nonperiodic distribution. Second, withholding may be waived by the participant if he or she desires. As a result, withholding on distributions that are not eligible rollover distributions is often called voluntary withholding.

Withholding on Periodic Payments that are Not Eligible Rollover Distributions

Withholding on periodic payments is determined in the same manner as withholding on wages, as if the payment was a payment of wages by an employer to an employee for the appropriate payroll period.[94]

EXAMPLE 9-20. Withholding on Periodic Payments. A participant in a pension plan elects distribution in the form of a QJSA. The annuity makes monthly payments in the amount of $4,000 during the participant's lifetime. If the participant’s spouse survives her, the monthly payments continuing to the surviving spouse equal $2,000 per month. The monthly payments are not eligible rollover distributions because they are substantially equal payments paid over the joint lives of the participant and the surviving spouse. Thus, the 20 percent withholding rules are not applicable. Instead, the payments are subject to the withholding tables for monthly wages.

Withholding on Nonperiodic Payments that are Not Eligible Rollover Distributions

The withholding rate on a nonperiodic payment is 10 percent of the amount includible in income.[95] Usually, a non-periodic distribution to a plan participant is an eligible rollover distribution, so the 20 percent withholding rule will apply instead. There are, however, nonperiodic payments that

[94] IRC §3405(a)(1).
[95] IRC §3405(b)(1).

would not meet the definition of an eligible rollover distribution, and so are subject to the 10 percent withholding:

- RMD portion of a nonperiodic distribution.
- Corrective distributions. These include the distribution of excess deferrals under the IRC §402(g) dollar limits, the distribution of excess contributions under the ADP test, and the distribution of excess aggregate contributions under the ACP test. In some cases, these distributions are subject to withholding. Generally, these distributions are subject to withholding only when they are taxed in the year of distribution.[96]
- Hardship withdrawals.
- IRA distributions. IRA distributions are not eligible rollover distributions for purposes of the withholding rules, regardless of whether they are eligible for rollover.
- Death distributions. Distributions made on account of the death of the participant are generally not considered eligible rollover distributions, except for certain payments to surviving spouses. However, for post-2006 distributions, non-spouse beneficiaries have a rollover option, and for post-2009 plan years, these death benefit distributions to non-spouse beneficiaries are considered to be eligible rollover distributions. Therefore, after 2009, the mandatory 20 percent withholding rule applies to death benefit distributions made to non-spouse beneficiaries to the extent that such amounts are not rolled over and are includible in gross income.

Election of No Withholding

An individual may elect out of withholding on distributions that are not eligible rollover distributions by filing Form W-4P. For periodic payments, the election remains in effect for future payments until revoked by the individual. The election generally is made on a distribution-by-distribution basis in the case of nonperiodic payments. Form W-4P cannot be filed to avoid withholding on an eligible rollover distribution. The only way to avoid withholding on an eligible rollover distribution is to elect a direct rollover.

Notice of Right to Elect Out of Withholding

IRC §3405(e)(10)(B) requires the payor to transmit notice of a payee's right to elect out of withholding. This duty is on the payor, even if the plan administrator has not shifted liability for the withholding to the payor.[97] The notice may be transmitted electronically.[98]

Failure to comply with this notice requirement is subject to a penalty of $10 per failure (maximum of $5,000 in any calendar year for all such failures by the payor), unless due to reasonable cause and not to willful neglect.[99]

Distributions to Beneficiaries

Because death benefit distributions made after 2009 are generally eligible rollover distributions, the 20 percent withholding rules apply. However, if the distribution (or portion of a distribution)

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[96] IRS Notice 87-77, 1987-2 C.B. 385.
[97] Treas. Reg. §35.3405-1, D-3.
[98] Treas. Reg. §35.3405-1, d-35 and d-36, 65 F.R. 6001 (February 8, 2000).
[99] IRC §6652(h).

is not eligible for rollover (e.g., payments under a QPSA paid pursuant to IRC §417), the voluntary withholding rules apply to that distribution (or portion of a distribution).

FORM 1099-R: REPORTING REQUIREMENTS

Plan distributions are reported on Form 1099-R. The form includes boxes for reporting the gross distribution and the taxable distribution. If a portion of the distribution is not includible in income, the taxable amount reported will be less than the gross distribution. Form 1099-R also will report the amount of employee contributions (basis) included in the distribution, the amount of federal income tax withheld and other pertinent tax reporting information.

Box 7 of the form provides identifying codes for the distribution being made. For example, the code may identify the distribution as subject to the 10 percent tax on early distributions. When a distribution is directly rolled over to another plan or to an IRA, the code in Box 7 will identify that a direct rollover has been made.

If part of a distribution is directly rolled over and the other part is not, two forms must be prepared, one to report the direct rollover and the other to report the distribution paid to the participant.[100]

Form 1099-R must be provided to the participant by January 31st of the calendar year following the year of the distribution. A copy of the form must be filed with the IRS by February 28th of the calendar year following the year of the distribution. A Form 1099-R need not be prepared for distributions that are less than $10.[101]

If You're Curious …

Penalty for Late Filing or Nonfiling of Form 1099-R

Form 1099-R is required by IRC §6047(d). The penalty for untimely filing of information returns and payee statements is determined under IRC §§6721 and 6722. The penalties were increased significantly for inflation with respect to forms due to be files after December 31, 2015.

Under IRC §6721, the penalty for failing to file the Form 1099-R with the IRS or a failure to provide correct information on the form is $250 per form, with no more than $3,000,000 for all failures in the same calendar year. The $250 penalty is reduced to $50 if the failure is corrected within 30 days of the due date, and to $100 if corrected in more than 30 days but by August 1 of the calendar year in which the filing date falls. The $3,000,000 maximum is also reduced to $500,000 and $1,500,000, respectively.

Under IRC §6722, the penalty for failing to provide Form 1099-R to the participant or beneficiary or failure to provide correct information on the payee statement is also $250 for each failure, with no more than $3,000,000 for all failures in the same calendar year, with the same reductions as under IRC §6721 to $50 (maximum $500,000) or $100 (maximum $1,500,000) depending on the timing. Lower caps on the penalty apply to persons with gross receipts of not more than $5,000,000 ($1,000,000, $500,000, and

[100] See the instructions to Form 1099-R for a complete list of reporting codes for Box 7.
[101] IRC §6047(d).

$180,000, instead of $3,000,000, $1,500,000, and $500,000, respectively). Higher penalties (with no cap) apply for an intentional disregard of the filing and statement requirements.[102] The IRS may waive the penalty for reasonable cause.[103]

Duty to Keep Records

The employer or the plan administrator has a duty to keep records necessary to provide proper reporting under Form 1099-R.[104] This includes proper records of each participant's basis in the plan. The penalty imposed under IRC §6704 is $50 multiplied by the number of individuals with respect to whom the failure occurs in a calendar year ($50,000 maximum).

Form 4852 Used to Report Discrepancies or Failure to Receive Form 1099-R

Suppose an employer (or payor) fails to issue Form 1099-R to an individual, or the individual disagrees with the information included on Form 1099-R but is unsuccessful in getting the employer (or payor) to issue a corrected form. The individual may submit Form 4852 with his or her tax return to report the missing (or corrected) tax information.

Elective Transfers Not Reported on Form 1099-R

The transferor plan in an elective transfer transaction, as described in Treas. Reg. §1.411(d)-4, Q&A-3, does not report the transferred amount on Form 1099-R. Although an elective transfer of distributable benefits is very similar in form to a direct rollover, a direct rollover is reported on Form 1099-R but an elective transfer is not. Presumably, the same rule applies to elective transfers made pursuant to IRC §411(d)(6)(D).

FORM 945: ANNUAL REPORT OF WITHHOLDING

Withholding from a plan is reported on an annual basis by filing Form 945, even if that withholding is done electronically. This form reconciles actual deposits with the income tax withholding liability. The return is due January 31 of the following calendar year. However, if deposits are made in full for the year, the Form 945 deadline is extended to February 12.

Deposits of withheld amounts are made on a monthly or semi-weekly basis, depending on the plan administrator’s (or payor’s) depositor status. Prior to 2011, withheld amounts were deposited with a federal tax depository using Form 8109 (Federal Tax Deposit Coupon), unless the withholding was deposited electronically through the IRS' electronic transfer system. Effective January 1, 2011,

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[102] Trade Preferences Extension Act of 2015 §806.
[103] See IRS Form 1586 for information about reasonable cause.
[104] IRC §6704.

electronic depositing is required for all depositors through use of the Electronic Federal Tax Payment System (EFTPS).[105]

Failure to File Form 945

Because Form 945 is a return required under IRC §6011,[106] it is subject to the failure to file penalty under IRC §6651. The penalty also applies to the failure to pay the tax required to be shown on the return (e.g., failure to withhold). The penalty is based on the amount of tax required to be shown on the return.

No Filing if No Withholding Was Required for Year

A Form 945 filing is not required for any year in which no withholding was required.[107] For example, suppose a profit-sharing plan makes its first distributions to which withholding rules applied in 2016. In 2017, no distributions are made from the plan. The plan administrator must file Form 945 for 2016, but not for 2017.

If You're Curious …

Failure To Withhold

The withholding party (the plan administrator or the payor, whichever is applicable) is liable for collection of the withholding tax and payment of the withholding tax to the IRS. If required withholding is not taken from the distribution, the IRS may recover the withholding tax (and interest on the late payment of the tax) from the withholding party. This is known as the trust fund recovery penalty under IRC §6672. The trust fund recovery penalty generally is abated if the income tax liability on the plan distribution is actually paid by the recipient.

Failure to Timely Deposit

If tax is withheld, but not deposited on a timely basis, a penalty applies under IRC §6656. The amount of the penalty depends on how late the deposit is. The penalty is 2 percent of the undeposited amount if the payment is not more than five days late, 5 percent of the undeposited amount if the payment is between five and 15 days late, and 10 percent of the undeposited amount if the payment is more than 15 days late. The penalty may be waived for reasonable cause. This penalty technically applies only when the tax is withheld but not deposited, not when the tax is never withheld.[108] The IRS has not specifically ruled whether it would apply these rules to withholding required with respect to a qualified plan distribution.

Collection Steps

If the required withholding has not been deducted from a plan distribution, the withholding party should make reasonable attempts to collect the withholding amount

[105] Treas. Reg. §31.6302-1(h)(2)(iii).
[106] Treas. Reg. §31.6011(a)-4(b).
[107] Treas. Reg. §31.6011(a)-4(b).
[108] Rev. Rul. 75-191, 1975-1 C.B. 376.

from the recipient of the distribution. If future distributions will be made to the recipient, the make-up withholding could be recovered from those distributions. To avoid the penalty under IRC §6651, the withholding party may need to pay the under withholding with Form 945, and seek a refund following the recipient's payment of the tax, or request a waiver of the penalty with the Form 945 filing.

Rollover to Ineligible Recipient Plan

If the plan administrator reasonably relies on adequate information provided by the distributee, the administrator is not subject to taxes, interest or penalties for failure to withhold on an eligible rollover distribution solely because the plan or account designated by the distributee does not qualify as an eligible retirement plan for rollover purposes.[109]

[109] Treas. Reg. §31.3405(c)-1, A-7.

9.10: Review of Key Concepts

- When is income recognized by plan participants?
- What types of contributions are taxed before they become part of a qualified trust?
- What is basis?
- What is a rollover?
- What is an eligible rollover distribution?
- Name types of distributions that are not eligible rollover distributions.
- Describe the tax impact of rolling a distribution into a Roth IRA.
- Describe the rules and the tax impact of an in-plan Roth rollover (or internal Roth conversion).
- What is the 10 percent tax on early distributions?
- Identify exceptions to the 10 percent tax on early distributions.
- What is the mandatory withholding amount on eligible rollover distributions that are not rolled over?
- Identify exceptions to the mandatory withholding rules.
- How are distributions and tax withholding reported to the IRS and to participants?
- What are the deadlines applicable to reporting distributions to the IRS and to participants?

9.11: For Practice – True or False

1. In general, employer contributions made on a participant's behalf to a qualified plan are taxable when distributed, not when contributed.
2. A participant may be able to avoid current taxation by rolling over a distribution to another qualified plan or to an IRA.
3. The 10 percent tax on early distributions applies to distributions made before a participant reaches NRA.
4. A participant will never be taxed on funds rolled to an IRA.
5. The 10 percent tax on early distributions is in addition to regular taxation applicable to the distribution.
6. A hardship withdrawal is an eligible rollover distribution.
7. Distributions made due to disability are exempt from the 10 percent tax on early distributions, regardless of the participant's age.
8. The 20 percent mandatory withholding rate on eligible rollover distributions that are not rolled over represents the actual tax rate for the participant.
9. After-tax employee contributions may be rolled into an IRA.
10. A plan administrator who fails to withhold federal taxes on distributions from qualified plans may be liable for the tax that should have been withheld.

9.12: Sample Test Questions

1. All of the following statements regarding taxation and distributions are TRUE, EXCEPT:

   A. After-tax employee contributions are excluded from taxation upon distribution.
   B. P.S. 58 costs are taxed to the participant in the year that insurance coverage is provided by the plan.
   C. Mandatory withholding does not apply on eligible rollover distributions if the participant rolls the money to an IRA within 60 days.
   D. Tax withholding applies to distributions of real property even if it requires selling all or a part of the property.
   E. QDRO distributions made to a former spouse are taxable to the former spouse, and not to the participant.

2. All of the following types of distribution are not eligible for rollover, EXCEPT:

   A. Hardship withdrawal
   B. RMD
   C. Death benefit payable to a spouse
   D. Corrective distribution of excess contributions
   E. Deemed distribution

3. All of the following distributions are exempt from the 10 percent tax on early distributions, EXCEPT:

   A. RMD
   B. In-service withdrawal made to a participant age 62
   C. Distribution to a participant separated from service at age 57
   D. Distribution due to death of a participant at age 45
   E. Distribution due to plan termination for a participant age 50

4. Which of the following statements regarding the 10 percent tax on early distributions is/are TRUE?

   I. Only the amount of the distribution that is includible in income is subject to the 10% tax on early distributions.
   II. Distributions from qualified plans used to pay for a participant's deductible medical expenses are exempt from the 10% penalty.
   III. Corrective distributions of excess deferrals under IRC §402(g) are exempt from the 10% penalty.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

5. All of the following statements regarding Form 1099-R reporting are TRUE, EXCEPT:

   A. Form 1099-R includes the amount of tax withheld, if any.
   B. Form 1099-R must be given to the participant by January 31 of the year following the year of distribution.
   C. Form 1099-R reports the applicability of the 10% tax on early distributions.
   D. Form 1099-R must be given to the IRS by April 15 of the year following the year of distribution.
   E. Distributions of less than $10 need not be reported on Form 1099-R.

6. Which of the following statements regarding Form 945 reporting is/are TRUE?

   I. Form 945 must be filed each year, even if there was no reporting liability.
   II. Form 945 reconciles actual deposits with withholding liability.
   III. The due date for Form 945 is January 31 of the calendar year following the year of distribution.

   A. I only
   B. II only
   C. I and III only
   D. II and III only
   E. I, II and III

7. All of the following statements regarding distributions to a Roth IRA are TRUE, EXCEPT:

   A. A designated Roth account (or any portion thereof) may be rolled over to a Roth IRA or to another designated Roth account under a 401(k) or 403(b) plan.
   B. If a designated Roth account is rolled over from a qualified plan into a Roth IRA, the money will retain the original 5-tax-year period.
   C. Defined contribution plan funds that are eligible for rollover, but are not designated Roth contributions, may be directly rolled over into Roth IRAs.
   D. If non-Roth funds are rolled into a Roth IRA, the taxable portion of the distribution is includible in gross income, in the same manner as a conversion of a traditional IRA to a Roth IRA.
   E. Once in a Roth IRA, accumulation of earnings on the rollover contribution will be tax-deferred and distributions of such earnings out of the Roth IRA may qualify for tax-free treatment.

8. Which of the following statements regarding withholding is/are TRUE?

   I. An RMD is not subject to mandatory 20% tax withholding because it is not an eligible rollover distribution.
   II. Periodic payments made in the form of a monthly annuity are subject to mandatory 20% tax withholding.
   III. Mandatory 20% tax withholding does not apply to noncash distributions.

   A. I only
   B. II only
   C. I and III only

D. II and III only
E. I, II and III

9. Which of the following statements regarding eligible rollover distributions is/are TRUE?

    I. A QDRO payment to a former spouse is not eligible for rollover.
    II. An in-service withdrawal of pre-tax elective contributions is eligible for rollover.
    III. A lump sum distribution due to disability is not eligible for rollover.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

10. Which of the following statements regarding internal Roth conversions is/are TRUE?

    I. A participant must pay taxes on the value of the converted accounts in the year in which the internal Roth conversion is made.
    II. A plan that has a designated Roth contribution feature must offer an internal Roth conversion option.
    III. Spousal consent is required for internal Roth conversions.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

See next page for answers to the true/false and sample test questions.

9.13: Solutions to True or False Questions

1. True.
2. True.
3. False. The 10 percent tax on early distributions applies to distributions made before a participant attains age 59½, unless an exception applies.
4. False. Current taxation is avoided by rolling the funds to an IRA. Amounts subsequently withdrawn from the IRA will be taxable at that time.
5. True.
6. False. Hardship withdrawals are not eligible for rollover treatment.
7. True.
8. False. The actual tax rate for a participant depends on his or her individual tax status. The mandatory withholding of 20 percent on amounts not rolled over is simply a credit toward the total amount of tax due from the participant for that tax year.
9. True.
10. True.

9.14: Solutions to Sample Test Questions

1. The answer is **C**. Mandatory withholding will apply on any eligible rollover distribution that is not directly rolled over. A participant may avoid current taxation by rolling over the proceeds to a qualified vehicle within 60 days, but if the rollover is not done directly, the mandatory withholding will still apply.
2. The answer is **C**. Death benefits payable to a spouse are eligible for rollover.
3. The answer is **E**. A distribution due to a plan termination is not exempt from the 10 percent tax on early distributions unless it meets a different exception to the 10 percent tax on early distributions.
4. The answer is **E**. All three statements are true.
5. The answer is **D**. Form 1099-R must be filed with the IRS by no later than February 28 of the year following the year of distribution.
6. The answer to this question is D. A Form 945 filing is not required for any year in which no withholding was required.
7. The answer is **B**. If a Roth account is rolled over into a Roth IRA, the 5-tax-year period will begin anew with regard to funds that were taxable at the time of rollover.
8. The answer is **A**. Periodic payments made in the form of a monthly annuity are not subject to mandatory 20% tax withholding. Withholding on periodic payments is determined in the same manner as withholding on wages, as if the payment was a payment of wages by an employer to an employee for the appropriate payroll period. There is no exception from the mandatory 20% withholding rules merely because noncash assets are distributed.
9. The answer is **B**. A QDRO payment to a former spouse is eligible for rollover. A lump sum distribution due to disability is eligible for rollover.
10. The answer is **A**. An eligible plan is not required to offer an internal Roth conversion option, even if the plan has a designated Roth contribution feature. Spousal consent is not required for internal Roth conversions.

CHAPTER 10:

DISTRIBUTIONS

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10.01: Key Terms

- Cure period
- Deemed distribution
- Defaulted loan
- Home loan
- Loan offset
- Qualified individual
- Refinancing
- Repaid loan amount
- Repayment period
- Replaced loan
- Replacement loan
- Step repayment

10.02: Introduction

The purpose of a retirement plan is to provide participants with the financial means for retirement. At times, the benefit is funded entirely by the employer; at others (for example, with 401(k) plans), the employees assist in the funding for retirement through elective contributions or after-tax employee contributions.

However, many plans allow participants access to their retirement accounts before a distributable event, at least on a temporary basis, by permitting participants to borrow from the plan, using their vested interest as security for the loan. Plans that allow participant loans and the participants who take advantage of the loan feature must follow strict rules to maintain plan compliance and prevent the loan from becoming a taxable event, a prohibited transaction, or a violation of the anti-alienation rules of the Internal Revenue Code (IRC).

A loan to a participant could violate three important statutes, resulting in taxes to the participant and potential disqualification to the plan:

- IRC §72, which outlines when amounts paid out of a plan are taxable to the participant who received them;
- IRC §401(a)(13) (a plan qualification requirement), which prohibits alienation of a participant's account in a qualified plan; and
- ERISA §406, in combination with IRC §4975, which prohibit transactions between the plan and— among others—a participant, and provide for excise taxation when such a transaction occurs.

All three of these statutes provide exceptions for participant loans, but those exceptions contain requirements that must be met. This chapter will discuss how these exceptions are applied so that participant loans are in compliance with the statutes.

10.03: Taxation Rules Affecting Participant Loans

Under IRC §72, funds paid to a participant from a qualified plan are presumably taxable. IRC §72(p) outlines the rules that must be followed to ensure that a loan is not taxed to the participant. These rules are discussed in this section. If these rules are violated, the loan will be taxable to the participant. If this occurs when the participant is eligible to take a distribution, a loan offset will

occur—that is, the loan proceeds will be considered to be a real distribution and will be removed permanently from the participant's account.

On the other hand, if the loan becomes taxable at a time when the participant is not permitted to take a distribution, the effect is a deemed distribution. A deemed distribution is a taxable event—that is, the taxation of loan proceeds to the participant—but not a real distribution. How deemed distributions are handled will be discussed later in this chapter. If an employer wants to make loans available under the plan, there needs to be language in the plan that authorizes the loans. The plan document may set forth all the specifics of the loan program, or instead may refer to a separate written loan policy that is adopted by the employer, the plan administrator, or other responsible person. The following are some questions the plan or loan procedure should outline with respect to the plan's participant loan program.

11. Who is eligible for loans? All participants? Beneficiaries of the participants? Only parties-in-interest, as defined in ERISA §3(14) (relating to the prohibited transaction rules)? The loan must be available to all participants and beneficiaries on a reasonably equivalent basis.[1]
12. What is the maximum loan available? IRC §72(p) places limits on participant loans that, if exceeded, will result in tax consequences. Although not required for qualification, most plans will not permit loans to exceed the IRC §72(p) limits so that the participant is not taxed on the loan. Furthermore, the plan might set lesser limits.
13. Will there be restrictions on the uses for the loan proceeds? There are no statutory rules that require such restrictions (other than the requirement to make loans reasonably available under the prohibited transaction exemption rules), but the employer might want to limit the reasons for which a loan will be available to participants.
14. What are the procedures for requesting and obtaining loans? Will all transactions be conducted solely with paper documents, or will the plan use electronic media? Spousal consent to the loan might also be required if the QJSA rules under IRC §417 apply to the participant.
15. What are the maximum loan terms, and how frequently will loan payments be made? IRC §72(p) places certain conditions on the repayment of loans for the loans to avoid taxation. However, the plan's loan program might require loans to be repaid over shorter terms, or with a greater amortization frequency, than IRC §72(p) requires.
16. May a participant request a loan if a prior loan is still outstanding? If yes, is there a limit on the number of separate loans a participant may have outstanding at one time? If multiple loans are permitted, the IRC §72(p) limits must be applied on the basis of all outstanding loan balances at the time each loan is made.
17. May an existing loan be refinanced at a later time, either to increase the principal amount, or to renegotiate interest or repayment terms? If yes, there are guidelines established in regulations issued by the Treasury. Refinancing options may be helpful, particularly in a plan that does not allow a participant to have more than one loan outstanding at a time.
18. How will a participant repay a loan from the plan? If the participant is currently employed by the employer, will payroll withholding be required, under which loan payments are deducted from each paycheck to keep the loan current? Such a requirement

[1] DOL Reg. §2550.408b-1(b).

minimizes the chances that loans will go into default, avoiding adverse tax consequences under IRC §72(p).

19. If an employee goes on a leave of absence, will the loan payment obligation be suspended? The IRC §72(p) regulations establish some conditions to avoid tax consequences for loan repayment suspensions permitted due to leaves of absence. The plan's loan program must set the parameters for loan suspensions. In addition, the plan might provide for less flexibility with respect to loan suspensions than the IRC §72(p) regulations permit.
20. What is the security for the loan? Generally, the loan is secured solely with the participant's vested account balance. However, if the loans exceed certain levels, additional security might be required. Furthermore, if loans are not earmarked for a particular participant's account balance (i.e., loans are held as general trust fund investments), fiduciary duties under ERISA might dictate the need for additional collateral. Finally, regulations require certain additional collateral to prevent tax consequences under IRC §72(p) if a loan is made to a participant who has previously defaulted on a plan loan and that defaulted loan remains unpaid.
21. What happens when a loan payment is missed? The loan provisions of the plan must define when a default occurs. To avoid tax consequences under IRC §72(p), missed payments must be made up before the end of a cure period established by the plan. A cure period is a period of time during which the participant may make up any missed loan payments to avoid suffering the tax consequences of a deemed distribution. IRC §72(p) sets limits on the length of that cure period.
22. When a participant terminates employment with the employer (either voluntarily or involuntary), does the participant loan become immediately due and payable? If not, will any other event, such as a request for distribution from the plan, require accelerated repayment of the loan? Some employers want to accelerate the due date of the loan after an employee terminates, because of the hassle of receiving loan payments by check, particularly when the payments are made through payroll withholding during the participant's active employment. On the other hand, acceleration may impose a financial hardship on a participant, and could result in significant tax consequences under IRC §72(p) if repayment is not made in a timely fashion. Whatever the decision here, the plan's loan provisions (or separate loan policy) must set forth any such accelerated payment rules, and the loan documents must also address them.

OVERVIEW OF THE IRC §72(P) REQUIREMENTS

IRC §72(p) treats a loan as a taxable distribution unless the loan satisfies the exception under IRC §72(p)(2). The exception sets limits on the amount of a nontaxable loan, and prescribes rules for repayment of the loan. The treatment of the loan as a distribution does not excuse the participant from the obligation to repay the loan. A failure to repay the loan may result in additional tax consequences and, in some cases, a prohibited transaction.

Enforceable Agreement Required

The regulations require that the loan be evidenced by an enforceable agreement that sets forth the:

- Amount of the loan;
- Date of the loan; and

- Repayment schedule.[2]

The enforceable agreement may be in the form of a written paper document or in an electronic medium. The principles set forth in Treasury regulations, regarding the use of electronic media to obtain participant consent to a distribution, apply to these transactions as well. The electronic medium must:

- Be reasonably accessible to the participant;
- Be reasonably designed to preclude any individual other than the participant from requesting a loan;
- Provide a reasonable opportunity for the participant to confirm, modify or rescind the terms of the loan before the loan is made; and
- Provide confirmation of the loan within a reasonable time after the loan is made. Confirmation may be provided in a paper document or electronically. If the confirmation is provided electronically, it must be designed in a manner that is no less understandable than a written paper document, and the participant must be advised that he or she may request a written paper document at no charge.[3]

Signature of Participant Not Necessarily Required

An agreement does not have to be signed by the participant, so long as under applicable law, the agreement is legally enforceable without a signature. The purpose of this clarification in the final regulations is to enable plans to process loans electronically without a signature, if such procedure does not compromise the enforceability of the loan agreement.[4] In addition, the Electronic Signatures in Global and National Commerce Act (ESIGN), enacted on June 30, 2000, gives legal effect to electronic loan transactions.

Written Document Required for Prohibited Transaction Exemption, Too

Loans also must be enforceable agreements to qualify for the prohibited transaction exemption under IRC §4975(d)(1) and ERISA §408(b)(1), which will be discussed further below.

Sham Loans

Failure to have an enforceable agreement will result in characterization of the loan as a distribution to the participant. A distribution may disqualify the plan if it is made at a time when a distribution is not authorized by the plan or before the statutory rules permit such distributions.

If You're Curious …

Pledges and Assignments of Participant's Account

[2] Treas. Reg. §1.72(p)-1, Q&A-3(b).
[3] Treas. Reg. §1.411(a)-11(f)(2).
[4] Treas. Reg. §1.411(a)-11(f)(2).

A pledge or assignment of a participant's account as security for a loan is treated as a participant loan from the plan for purposes of IRC §72(p). IRC §72(p)(1)(B) provides, in relevant part:

If during any taxable year a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his or her interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan.

The amount of the pledge or assignment is treated as the loan amount. However, if the loan for which the account is pledged or assigned is received from the plan (or from a contract purchased by the plan), only the actual amount of the loan received, not the amount pledged or assigned, is treated as a loan.

To illustrate, suppose a participant receives a loan of $20,000 from the plan, for which the plan takes a security interest equal to 50 percent of the participant's vested account balance. Only $20,000, which is the actual amount of the loan, is treated as a loan under IRC §72(p), even if 50 percent of the participant's vested interest exceeds $20,000, because the loan is from the plan. However, suppose the participant goes to a bank for a loan equal to $20,000, but the bank has the participant pledge $40,000 of the value of his or her account balance in a qualified plan as security for the loan. Because the loan is not made from the plan, the amount subject to IRC §72(p) is $40,000, which is the amount pledged, not $20,000.

Plans Subject to IRC §72(p)

Plans that are subject to the rules of IRC §72(p) include:

- Qualified plans under IRC §401(a);
- Annuity plans described in IRC §403(a) (which are subject essentially to the same requirements as listed under IRC §401(a) and are also treated as qualified plans);
- Plans described in IRC §403(b) [i.e., 403(b) plans, including tax-sheltered annuities described in IRC §403(b)(1) and custodial accounts described in IRC §403(b)(7)];
- Any governmental plan, regardless of whether it is qualified under IRC §401(a); and
- Any plan which ever was (or was determined to be) described in the above categories.[5]

Summary of Other IRC §72(p) Rules

Here is a summary of the main issues addressed in IRC §72(p) and the underlying regulations:

- The maximum amount of a participant loan without incurring tax consequences under IRC §72(p);
- The repayment requirements that must be provided in the terms of the loan in order to avoid tax consequences under IRC §72(p);
- The tax consequences of a deemed distribution under IRC §72(p) and how that affects Form 5500 reporting;

[5] IRC §72(p)(4) and Treas. Reg. §1.72(p)-1, Q&A-2.

- Rules for offsetting an unpaid loan and the tax and reporting requirements relating to loan offset;
- Limitations on a participant's right to take income tax deductions for interest paid on participant loans; and
- Exemption of residential mortgage investment programs from IRC §72(p).

LIMITS ON AMOUNT OF NONTAXABLE LOAN

IRC §72(p)(2) sets a limit on the amount of a participant loan that will not be treated as a deemed distribution.

General Limit: 50 Percent of Vested Interest

A participant may receive a nontaxable loan that equals up to 50 percent of his or her vested accrued benefit, subject to a cap of $50,000.[6]

$10,000 Minimum Provides Exception to 50 Percent Rule

A loan up to $10,000 is not taxable, even if the amount exceeds 50 percent of the participant's vested accrued benefit.[7] However, under Labor regulations, a loan may not be secured by more than 50 percent of the vested accrued benefit.[8]

This limit on the security interest is a condition of the prohibited transaction exemption available for the loan under IRC §4975(d)(1) and ERISA §408(b)(1). If a plan will make a loan that exceeds 50 percent of the vested accrued benefit under this $10,000 minimum rule, collateral in addition to the participant's vested interest will be required to satisfy the prohibited transaction exemption.

EXAMPLE 10-1. $10,000 de minimis Loan. Sidney's vested account balance in his employer's profit-sharing plan is $14,000. Although 50 percent of his vested account is $7,000, IRC §72(p) permits the plan to make a nontaxable participant loan to Sidney in an amount up to $10,000. However, the loan cannot be secured solely with the account balance because of the prohibited transaction exemption requirements. Therefore, Sidney will need to provide additional security acceptable to the plan in order to take the additional loan amount.

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[6] IRC §72(p)(2)(A).
[7] IRC §72(p)(2)(A)(ii).
[8] DOL Reg. §2550.408b-1(f).

In light of the prohibited transaction issue, few plans take advantage of the $10,000 de minimis loan availability, and plans typically limit participant loans to no more than 50 percent of the vested accrued benefit.

If You're Curious …

Congress sometimes takes action to expand loan availability for participants affected by natural disasters such as hurricanes and severe storms. For example, Congressional action in the wake of the Hurricanes Harvey, Irma and Maria increased loan limits for taxpayers affected by the hurricanes.[9] A qualified individual for these increased loan limits is generally an individual whose principal place of abode on the applicable date was located in the disaster area and who sustained an economic loss by reason of the natural disaster.

In such instances, Congress will declare an applicable period in which a loan is eligible for relief. The periods typically begin shortly after the natural disaster occurs and end on the second December 31 following the event. For example, in the case of three hurricanes, the loan relief period ran from September 2017 through December 31, 2018.[10] If the due date of the loan or any repayment date with respect to the loan occurred during the applicable period, the due date was delayed for one year.

OUTSTANDING BALANCE OF ALL LOANS CONSIDERED FOR LOAN LIMITS

If a plan makes a loan to a participant when a prior loan balance is still outstanding, the amount of the new loan and the balance on the existing loan must be aggregated to determine whether the limit is exceeded.[11]

EXAMPLE 10-2. Loan Limit Takes into Account Existing Loans. Minnie's vested account balance is $30,000 including an outstanding loan balance of $13,000. She has requested a loan in the amount of $3,000. The plan permits a participant to have more than one outstanding loan.

Minnie's nontaxable loan limit under IRC §72(p) is 50% x $30,000, or $15,000. If Minnie is given a second loan in the amount of $3,000, she will exceed the limit because her outstanding loan balance, taking into account both the first loan (which still has a balance of $13,000) and her second loan (with an initial balance of $3,000) will be $16,000.

[9] Gulf Opportunity Zone Act of 2005, Katrina Emergency Tax Relief Act of 2005, Heartland, Habitat, Harvest, and Horticulture Act of 2008, §15345(a)(7); Emergency Economic Stabilization Act of 2008, §702(a)(1)(D), Notice 2005-92, Announcement 2005- 70.
[10] The time during which the extended loans may be taken was extended to January 1, 2010 for all disasters as part of the Emergency Economic Stabilization Act, §702.
[11] IRC §72(p)(2)(A).

EXAMPLE 10-3. Multiple Loans. A 401(k) plan allows a participant to request multiple loans, without limitation, as long as the limits under IRC §72(p) are not exceeded. During 2020, a participant requests and receives the following loans:

$12,000 on February 1, 2020
$2,500 on April 10, 2020
$4,000 on September 1, 2020
$3,300 on December 9, 2020

There are no prior loans outstanding when the February 1 loan is made. None of the loans made during 2019 results in tax consequences, as long as the IRC §72(p) limits are satisfied.

To determine if the IRC §72(p) limits are exceeded, the plan must look at the participant's vested account balance as of the date of each loan and the outstanding balance of all outstanding loans as of such date. The following table summarizes the applicable calculations.

The IRC §72(p) limit is assumed to be 50 percent of the participant's vested account balance. Note that, if the account balance were greater, the $50,000 limit (as adjusted for the prior loans) might result in a lower limit.

(a) Date of Loan	(b) Principal Amount of Loan	(c) Outstanding Balance on Existing Loans	(d) Total Loans ((b) + (c))	(e) Vested Account Balance	(f) IRC §72(p) (2)(A) limit (50% × (e))
02/01/20	$12,000	$0	$12,000	$45,000	$22,500
04/10/20	$2,500	$11,800	$14,300	$46,700	$23,350
09/01/20	$4,000	$13,700	$17,700	$46,500	$23,250
12/09/20	$3,300	$17,200	$20,500	$47,900	$23,950

In each case, the amount in column (d) is less than the amount in column (f), so the IRC §72(p) limits are not exceeded. So long as each loan also satisfies the other requirements of IRC §72(p), there are no tax consequences.

Reduction of $50,000 Limit for Certain Prior Loans

When a new loan is made to a participant, the $50,000 limit is reduced by the repaid loan amount during the last 12 months.[12] The repaid loan amount is the highest loan balance in the prior 12-

[12] IRC §72(p)(2)(A)(I).

month period, reduced by any outstanding loan balance at the time of the new loan. The general effect of this rule is to limit the total principal amount lent during any 12-month period to $50,000.

EXAMPLE 10-4. First Loan is Less than $50,000. Franklin's vested account balance in his employer's plan is $150,000. The nontaxable loan limit is $50,000. On February 1, 2020, Franklin receives a participant loan of $45,000.

On September 1, 2020, the outstanding balance of the loan is $40,000. The repaid loan amount is $5,000, which is the difference between the highest loan balance in the last 12 months ($45,000) and the outstanding loan balance ($40,000).

The maximum loan limit is reduced by $5,000 to $45,000. Franklin may request another loan up to $5,000 ($50,000 minus the repaid loan amount of $5,000, minus the currently outstanding loan of $40,000) without exceeding the IRC §72(p) limit.

Another way to look at this is that a new loan of $5,000, when added to the outstanding loan balance of $40,000, will equal the current adjusted limit of $45,000. Note that with this adjustment, the maximum principal lent to Franklin during the year is $50,000 ($45,000 on February 1 and $5,000 on September 1).

EXAMPLE 10-5. First Loan is $50,000. Suppose, in EXAMPLE 10-4, that Franklin's original loan on February 1, 2020, was for $50,000, and the outstanding balance of that loan is $42,000 on September 1, 2020.

The repaid loan amount during the 12-month period is $8,000, reducing the $50,000 limit to $42,000. This adjusted limit equals Franklin's current loan balance, so a new loan cannot be made without exceeding the IRC §72(p) loan limit.

As this example illustrates, if a balance of $50,000 existed at any time during the prior 12 months, a new nontaxable loan is not permitted. This is true even if the participant fully repays that loan before requesting the second one.

EXAMPLE 10-6. Full Repayment of First Loan Before Receiving Second One. Suppose in EXAMPLE 10-5, Franklin fully repays the February 1, 2020, loan on August 15, 2020. He then requests a new $50,000 loan on September 1, 2020. Now Franklin's $50,000 limit is reduced to $0, because the difference between his highest outstanding balance in the last 12 months ($50,000) and his current outstanding balance ($0) is $50,000. By having this rule, Franklin is unable to effectively obtain a fresh start on his five-year repayment term for the $50,000 loan.

If You're Curious …

Applying the $50,000 Limit When There Are More Than Two Loans in a 12-Month Period

Where there have been more than two loans in the last 12 months, remember to take the highest outstanding loan balance at any time in the 12-month period, and subtract the current loan balance at the time of the new loan to determine the adjusted maximum loan limit. As the following EXAMPLE 10-7 illustrates, it is possible under a very narrow set of circumstances to lend out more than $50,000 in a 12-month period, so long as the outstanding loan balance at any time is not greater than the adjusted maximum dollar limit.

EXAMPLE 10-7. More than Two Loans Within a Year. Priscilla receives a loan in the amount of $26,000 on March 1, 2020. On September 1, 2020, when the outstanding balance of the March loan is $25,000, she receives a new loan for $21,000. On December 1, 2020, she wants to take a third loan for the maximum permitted amount. At all times, her vested account balance exceeds $100,000.

At the time of the September loan, the $50,000 maximum is reduced to $49,000 because her highest balance in the last 12 months was $26,000 and the current balance as of September 1 was $25,000, resulting in a $1,000 reduction to the $50,000 maximum.

At the time of the December 1 loan, the highest outstanding balance in the last 12 months was $46,000 (as of September 1, when the original loan was valued at $25,000 and the new loan was valued at $21,000).

Suppose the current loan balance as of December 1, 2020, is $44,000 ($24,000 on the first loan and $20,000 on the second loan). The difference between the highest loan balance ($46,000) and the current loan balance ($44,000) is $2,000. Therefore, the $50,000 maximum is reduced to $48,000. The maximum new loan on December 1 is $4,000 (that is, the $48,000 maximum, minus the current outstanding loans of $44,000).

Loan	March 1 Balance	Sept. 1 Balance	Dec. 1 Balance
Loan 1	$26,000	$25,000	$24,000
Loan 2	N/A	$21,000	$20,000
Loan 3	N/A	N/A	$4,000
Total Loans	$26,000	$46,000	$48,000
IRC §72(p)	$50,000	$49,000 [$50,000 − ($26,000 − $25,000)]	$48,000 [$50,000 − ($46,000 − $44,000)]

If the amount of loans taken during the 12-month period is added together, the total is $51,000 ($26,000 + $21,000 + $4,000). However, the $50,000 maximum was never exceeded because of the timing of the loans and their repayments.

Highest 12-Month Outstanding Balance Issue Not Applicable to 50 Percent Limit

The reduction described above is applicable only to the $50,000 limit. A participant's 50 percent loan limit is not reduced by this highest outstanding balance calculation.

EXAMPLE 10-8. 50 Percent Limit Applies. Sheila's vested account balance on March 1 is $28,000. She receives a loan on that date of $10,000. On September 1 of the same year, the outstanding balance of that loan is $9,600. Her vested account balance is now $30,000.

She receives a second loan for $5,400. Her IRC §72(p) limit as of September 1 is $15,000 (i.e., $30,000 x 50%). This limit is not exceeded because the outstanding balance on the first loan ($9,600) plus the balance of the second loan ($5,400) equals $15,000.

Sheila's 50 percent limit as of September 1 is not reduced by $400, which is the difference between the highest outstanding loan balance in the last 12 months ($10,000) over the current loan balance on September 1 ($9,600). That type of adjustment is only done with the $50,000 limit.

In other words, the $50,000 would be reduced by $400 to $49,600 in this example, but Sheila's loans at any time are nowhere near this limit, and the 50 percent limit under IRC §72(p) is well below the $49,600 limit anyway.

Valuing the Vested Accrued Benefit

The latest valuation of the accrued benefit must be used to determine the 50 percent nontaxable loan limit.[13] The latest valuation must be increased by any contributions allocated after the valuation date and before the date of the loan. The latest valuation also must be decreased by any distributions made after the valuation date and before the date of the loan. Changes in the value of the accrued benefit after the loan is made do not affect whether the loan satisfied the IRC §72(p) limits.

EXAMPLE 10-9. Value of Vested Accrued Benefit for Loan Purposes. A profit-sharing plan values account balances quarterly. The plan includes a 401(k) arrangement. Elective contributions are credited on a monthly basis. A participant is receiving a loan on August 1. The previous June 30 value is used, increased for elective contributions credited between that date and the date of the loan. If the participant received any distribution from the plan after June 30 and before August 1, the value is reduced by such amount.

The 50 percent limit is not affected by changes in the value of the accrued benefit that occur after the loan has been made, even if the outstanding loan balance exceeds 50 percent of the value of the vested account balance after a decline in the account's value.

EXAMPLE 10-10. Value of Vested Interest for Loan Purposes Not Affected by Decline in Value After Loan Date. On September 15, a participant receives a

[13] IRS Notice 82-22.

plan loan in the amount of $17,000, which equals 50 percent of her vested account balance as of the latest valuation date. Her account is revalued as of September 30. Due to a sharp decline in the value of many of the investments held in her account, the vested account balance as of September 30 is $28,000. The outstanding balance of the September 15 loan is still $17,000 because no payments have been made yet on the loan. Although $17,000 exceeds 50 percent of $28,000, the loan limit is not exceeded because the 50 percent limit was satisfied when the loan was made.

If the plan permits the participant to have more than one loan outstanding, a devaluation of the account may affect the availability of additional loans. In the above EXAMPLE 10-10, the participant could not take a new loan until the outstanding balance of her existing loan falls below 50 percent of the current value of her vested account balance.

The 50 percent limit is not affected by distributions taken by the participant after the date of the loan, even if the outstanding loan balance exceeds 50 percent of the value of the vested accrued benefit that remains after the distribution.

EXAMPLE 10-11. Value of Vested Interest for Loan Purposes Not Affected by Distributions After Loan Taken. Maya needs $15,000 for her son's college expenses. Her employer's 401(k) plan permits hardship withdrawals for this purpose.. In 2018, Maya's vested account balance is $22,000. The plan permits loans up to 50 percent of the vested account balance. Maya borrows $11,000 and then requests a hardship withdrawal for $4,000 to cover the remaining college expenses.

Immediately after the hardship withdrawal, her vested account is only $18,000, $11,000 attributable to the outstanding loan and $7,000 attributable to other investments. Although the outstanding loan balance equals 61 percent of her vested account immediately after the distribution, the 50 percent loan limit is not exceeded because at the time of the loan the 50 percent limit was satisfied.

Total vested account:	$22,000
Amount of loan:	$11,000
Hardship withdrawal (occurs after loan):	$4,000
Breakdown of account after hardship withdrawal:	
Loan asset:	$11,000
Other assets:	$7,000
Total vested account after hardship withdrawal:	$18,000
Loan as percentage of vested account immediately after hardship withdrawal:	61%

Difficulties Experienced by Daily Valued Plans

Daily valued plans may experience significant swings in the value of a participant's vested account balance between the time the loan process commences and the time the loan is actually disbursed from the plan. As a practical matter, how should the plan apply the 50 percent loan limit (or any lesser limit under the plan) in this context? The IRS does not provide any guidance here, primarily because in 1982, when the loan regulations were issued, daily valued plans were not on the radar

screen. The guidance does say, however, that "a valuation of the participant's interest within the last twelve months may be used, provided it is the last valuation available."[14]

Reasonable administrative procedures should be established to ensure that the most recent daily valuation possible is used. For example, the value in effect when the loan obligation becomes fixed (i.e., necessary signatures and consents are obtained) should be a reasonable approach in the absence of more formal guidance from the IRS. In addition, the employer should consider addressing the issue in the loan policy. An approach used by some employers is to set the plan's loan limit at less than the statutory maximum (e.g., 40 percent or 45 percent).

Value of Account Includes Amount Attributable to Outstanding Loans

Remember that, when the plan makes a loan to the participant, the plan is making an investment, and the loan is an asset of the plan. If the plan has participant-directed investments (or even if only the loan is considered to be an earmarked investment of the participant's account), the value of the account the moment after the loan is taken has not changed.

Consider, for example, a participant who has an account balance of $50,000, which is invested entirely in a money market account. On the date the participant takes a loan of $25,000 (50 percent of his or her plan interest), the assets in his or her account are converted to $25,000 in the money market and $25,000 in a loan receivable from the participant.

This is important in determining the value of the participant's vested account balance when a second loan is applied for. The value of the participant's vested account balance includes any outstanding participant loan (or the portion of the loan attributable to the participant's account, where loans are held as general trust investments rather than as earmarked investments). If the outstanding loans are not included in the assets that make up the participant's vested account balance, the participant's loan limit under the 50 percent rule could be understated or overstated, depending on how the plan administrator incorrectly applies the rules.

EXAMPLE 10-12. Value of Vested Interest Includes Outstanding Loans. A participant's account balance is $30,000 at the time his first loan is taken from the plan. The participant is 100 percent vested in that account. That loan is for $9,000, which is within the 50 percent limit of $15,000 (i.e., $30,000 x 50%). Several months later, the participant applies for a second loan. The plan's loan policy permits multiple loans. At the time of the second loan, the outstanding balance on the first loan is $8,500. The loan is an earmarked investment of the participant's account.

The participant's account's non-loan investments total $23,400 at the time of the second loan. Thus, the proper determination of the participant's vested account balance is to total the outstanding loan ($8,500) (which is an asset of his account) and the value of the non-loan investments ($23,400), yielding a vested account

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[14] IRS Notice 82-22.

balance of $31,900. Thus, at the time of the second loan, the 50 percent limit is $15,950 (i.e., 50% x $31,900).

The maximum permissible amount for the second loan is $7,450, which is determined by subtracting the outstanding loan balance ($8,500) from the 50 percent limit ($15,950). If the participant borrows the maximum permissible amount, he will have two loans outstanding immediately after the transaction, one for $7,450, and one with a remaining balance of $8,500, the sum of which is exactly 50 percent of the participant's vested account balance of $31,900.

If the outstanding loan in the prior EXAMPLE 10-12 were to be disregarded in computing the vested account balance, the vested account balance would be incorrectly determined to be only $23,400, yielding a 50 percent limit of $11,700. If the outstanding loan balance were then subtracted from $11,700, the maximum amount of the second loan would be incorrectly determined to be only $3,200. This is understating the loan limit.

Tax Impact if Loan Limit Is Exceeded

If a loan to a participant is in excess of the IRC §72(p) limit, how much of the loan is treated as a taxable distribution? IRC §72(p)(2) provides that only the portion of the loan in excess of the limit is taxable. This is the approach taken by the IRS in Miller & Miller v. Commissioner,[15] and is provided for in the regulations as well.

All Plans Aggregated

All plans of the employer are treated as a single plan to determine the nontaxable loan limit.[16]

EXAMPLE 10-13. More than One Plan. An employee has a $160,000 vested account balance in a profit-sharing plan, and a $150,000 vested account balance in a money purchase plan maintained by the same employer. The vested account balance in each plan exceeds $100,000, so the maximum non-taxable loan amount is $50,000. A separate $50,000 limit cannot be applied to each plan. If the employee receives two loans, one from each plan, the combined loan amount may not exceed $50,000.

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[15] 95-1 U.S.T.C. ¶50,024 (6th Cir. 1994); Treas. Reg. §1.72(p)-1, A-4.
[16] IRC §72(p)(4).

A related group of employers, as described in IRC §414(b), (c), or (m), is treated as a single employer in applying this rule.[17]

Security Interest Not Based on Aggregated Value

The DOL regulations do not aggregate plans in applying the adequate security rules. No more than 50 percent of the vested account balance (or present value of vested accrued benefit, in a defined benefit plan) under the plan making the loan may be considered security for that loan.[18]

Plan's Loan Provisions May Set Lesser Limits

The above limits are the maximum allowed by statute to avoid tax consequences under IRC §72(p). The plan's loan program is not required to allow participants to take the maximum loans permitted by law. The plan (or the loan program) may limit loans to a lower percentage of the vested account balance, or set a dollar limit that is less than $50,000. The terms of the plan documents control.

REPAYMENT REQUIREMENTS

To be nontaxable, the repayment period for a participant loan, by its terms, must be not more than five years (or 60 months), unless it is a principal residence loan.[19] For example, a loan made on September 1, 2019, must, by its terms, be fully repaid by August 31, 2024, unless the loan qualifies for the principal residence exception. In addition, IRC §72(p) sets minimum requirements on the amortization frequency of the loan.[20]

What is the date of the loan? In a Q&A session with the American Bar Association (ABA), the IRS agreed that the date of the loan for purposes of the five-year repayment rule is the date the check is delivered to the participant, not the date the loan application or the promissory note is signed.[21]

Loan repayment deadlines were postponed for taxpayers affected by the September 11, 2001 terrorist attack, those affected by Hurricanes Katrina, Rita, Wilma, or Matthew, and those affected by the 2008 Midwest storms.[22] In addition those affected by the 2017 hurricanes Harvey, Irma, and Maria were treated similarly. In 2019 Congress enacted legislation that applies relief on the repayment of loans if the participant is located in a federally declared disaster area. In this relief the loan maximum amounts are increased to the lesser of $100,000 or 100% of the vested account balance. Loan repayment time frames are increased by one year.

Level Amortization/Quarterly Minimum Frequency

During the repayment period, principal and interest must be amortized in substantially level payments that are made at least on a quarterly basis.[23] A balloon payment of principal would not

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[17] IRC §72(p)(2)(D).
[18] DOL Reg. §2550.408b-1(f).
[19] IRC §72(p)(2)(B)(i).
[20] IRC §72(p)(2)(C).
[21] Q&A-4 of the 2004 Joint Committee of Employee Benefits Meeting with the IRS (May 7, 2004), available at the ABA's website.
[22] Notice 2001-68, Gulf Opportunity Act of 2005, Emergency Economic Stabilization Act of 2008.
[23] IRC §72(p)(2)(C).

satisfy IRC §72(p). The level amortization requirement applies even if the repayment period is longer than five years because of the principal residence exception described below. Presumably, the loan note may permit an employee to accelerate repayment of the loan, even though additional payments would not be level with the scheduled amortization payments.

Modifications to Amortization Period, Loan Amount, or Repayment Terms (Refinancing)

The regulations under IRC §72(p) provide guidance on modifications to the amortization period, loan amount, or repayment terms after the origination date of the loan.[24]

Refinancing a Loan

Refinancing transactions are transactions in which one or more existing loans are replaced by a new loan. The loan being replaced is treated as repaid after the refinancing transaction is completed. For purposes of our discussion, we will adopt the terminology used in the regulations. The loan being replaced is referred to as the **replaced loan**. The new loan resulting from the refinancing transaction is referred to as the **replacement loan**.[25]

Refinancing transactions may be of particular assistance to a participant when the plan's loan program does not permit more than one loan to be outstanding at a time. By refinancing, the participant would be able to borrow additional funds, extend the amortization period or renegotiate more affordable loan terms, without violating the plan's prohibition on multiple loans.

Replacement loan treated as a new loan. A replacement loan is treated as a new loan for purposes of IRC §72(p). That means the interest rate and the security interest on the replacement loan must be determined as of the date of the refinancing. Thus, the interest rate under the replaced loan might not be an appropriate interest rate under the replacement loan, because the plan must now redetermine the commercially reasonable interest rate. In addition, the 50 percent loan limit must be redetermined to take into account the participant's vested accrued benefit as of the date of the refinancing.

Substantially level payments under replacement loan. Because the replacement loan is a new loan, and the replaced loan is considered repaid by the replacement loan, the fact that the amortization payment under the replacement loan is different from the amortization payment under the replaced loan does not cause the replacement loan to violate the requirement that principal and interest be amortized in substantially level payments. However, see below for possible limitations on how the amortization schedule is structured under the replacement loan if the term of the replacement loan ends later than the maximum permissible term of the replaced loan.

What is the maximum loan term for the replacement loan? Because the replacement loan is a new loan for IRC §72(p) purposes, its term may run for the maximum five-year period (or longer period, if the loan is a principal residence loan). However, to prevent the use of refinancing as a means of circumventing the IRC §72(p) repayment requirements, the replaced loan may need to

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[24] Treas. Reg. §1.72(p)-1, Q&A-20.
[25] Treas. Reg. §1.72(p)-1, Q&A-20.

be taken into account to determine whether the limits on loan amounts are exceeded by the replacement loan.

If the term of the replacement loan ends later than the latest permissible term of the replaced loan, limits on the loan amount are applied as if the replaced loan is still outstanding on the date of the replacement loan.[26] Thus, if the sum of the amount of the replacement loan and the outstanding balance of the replaced loan (plus any other existing loans not being replaced) exceeds the loan amount limitations under IRC §72(p), the excess is taxed as a deemed distribution.

EXAMPLE 10-14. Determining Maximum Refinanced Loan When Loan Repayment Date Extends Beyond Original Maximum Loan Repayment Date. Suppose a replacement loan is made on April 1, 2018, for $9,000, payable over five years ending March 31, 2023. The replacement loan will be used to repay the outstanding balance of $5,500 on an existing loan payable for a 5-year term ending October 31, 2020 (the replaced loan), and to disburse an additional $3,500 to the participant. Further assume there are no other outstanding loans.

Because the term of the replacement loan (i.e., April 1, 2018, to March 31, 2023) ends later than the latest permissible term of the replaced loan (i.e., October 31, 2020), the participant's outstanding loan balance on April 1, 2018, is treated as $14,500 (i.e., the sum of the replacement loan and the replaced loan) to determine the maximum amount of the loan. If $14,500 exceeds the maximum loan limit, there is a deemed distribution under IRC §72(p) for the amount by which the replacement loan causes the limit to be exceeded. On the other hand, if the sum of these amounts satisfies the maximum loan limit, the use of the maximum repayment period under the replacement loan will not result in a deemed distribution.

After applying the loan limits to the combination of the replacement loan and the replaced loan, the replaced loan would then be treated as repaid by the replacement loan and would not be taken into account with respect to any subsequent loan made to the participant.

If the term of the replacement loan ends no later than the latest permissible term of the replaced loan, the replaced loan need not be taken into account when determining the maximum loan limit for the replacement loan. Thus, the replaced loan is treated as repaid before the replacement loan starts, and the loan limits are applied only to the replacement loan (and any other loans still outstanding that are not being replaced by the replacement loan).

EXAMPLE 10-15. Determining Maximum Refinanced Loan When Loan Repayment Date Does Not Extend Beyond Original Maximum Loan

[26] Treas. Reg. §1.72(p)-1, Q&A-20(a)(2).

Repayment Date. Assume that in the situation described in EXAMPLE 10-14 that the term of the replacement loan also ends on October 31, 2020, which is the same as the maximum permissible term of the replaced loan.

The maximum loan limit is applied only to the replacement loan of $9,000 as if no other loans are outstanding, even though the replacement loan is partly being used to repay the outstanding balance on the replaced loan.

EXAMPLE 10-16. Original Repayment Terms on Replaced Loan were Less than Five Years. Assuming the same facts as in EXAMPLE 10-14, suppose that the replaced loan, with a term ending on October 31, 2020, originated on November 1, 2017 (i.e., the loan only had a three-year amortization period). The latest permissible term for the loan (assuming no principal residence exception or military leave exception) would be October 31, 2022. Thus, as long as the amortization period of the replacement loan made on April 1, 2018, does not end later than October 31, 2022 (i.e., the maximum repayment term for the original replaced loan), only the replacement loan of $9,000 would be taken into account to determine if the maximum loan limit is exceeded.

If You're Curious …

***Structuring the amortization schedule to avoid deemed distribution under a longer-term replacement loan* (step repayment).** If the term of the replacement loan exceeds the latest permissible term of the replaced loan, there is an alternative, even though the sum of the replaced loan and the replacement loan would cause the maximum loan limits to be exceeded. To satisfy this exception, the replacement loan must be analyzed as if it was actually two separate loans—one representing the replaced loan, amortized in substantially level payments over a period ending no later than the last day of the original term of that replaced loan, and the other one representing the difference between the amount of the replacement loan and the outstanding balance of the replaced loan. In other words, notwithstanding the fact that the replaced loan and the replacement loan are now documented as one loan, they are being separately amortized and neither loan will, by itself, exceed its maximum repayment period. As such, this structure does not circumvent IRC §72(p) so there is no need to take into account the outstanding balance of the replaced loan to determine whether the amount of the replacement loan satisfies IRC §72(p). When this exception applies, the plan may disregard the replaced loan to determine if the loan limitations are violated.[27]

As shown in the following examples, the more room a participant has on his or her loan limits (i.e., the greater the difference between the maximum loan limit and the outstanding balance on the replaced loan), the more flexibility there is in setting the terms

[27] Treas. Reg. §1.72(p)-1, Q&A-20(b).

of the replacement loan. If the replaced loan is also for a term that is less than the maximum permissible term, there is even more flexibility in a refinancing transaction.

EXAMPLE 10-17. Increasing Loan and Starting New 5-year Term. Will has a vested account balance of $23,000 as of December 1, 2017. He receives a loan for $8,000. The loan bears the maximum five-year payment term, so the loan will not be fully amortized until November 30, 2023.

On June 1, 2019, Will has an outstanding balance of $6,000 on the original loan. As of that date, his vested account balance is $32,000. Will's loan limit is now $16,000 (i.e., 50% x $32,000), $6,000 of which is outstanding. Will needs $4,000 additional cash. The plan provides Will with a replacement loan on June 1, 2019, that increases his principal balance by $4,000, and restarts the five-year repayment term so that it will now end on May 31, 2022. The replacement loan requires monthly amortization (deducted through payroll withholding). The principal of the replacement is $10,000, which represents the $4,000 of additional cash given Will and the $6,000 outstanding balance on the original loan (i.e., the replaced loan). In other words, the replacement loan pays off the outstanding balance of the replaced loan, and also gives Will another $4,000.

This transaction satisfies the refinancing requirements. The replaced loan had an outstanding balance of $6,000. The replacement loan is for $10,000. Because the repayment term of the replacement loan ends after the term of the replaced loan, the plan must treat both loans as outstanding on June 1, 2019, to determine if the maximum loan limits have been exceeded. If we add the loans together, we get a total of $16,000. This exactly equals 50 percent of Will’s vested interest as of the refinancing date of $32,000. In addition, the repayment rules of IRC §72(p) have not been violated by either loan.

(1) Vested balance on 6/1/2019:	$32,000
(2) Loan limit on 6/1/2019:	$16,000
(3) Outstanding balance on replaced loan (as of 6/1/2019):	$6,000
(4) Latest permissible term on replaced loan described in (3):	11/30/2022
(5) Additional cash disbursed on 6/1/2019:	
$4,000 (6) Replacement loan on 6/1/2019 ((3) + (5)):	$10,000
(7) Term of replacement loan:	5/31/2022

Because (7) is later than (4), IRC §72(p) applies to the sum of the replaced loan and the replacement loan.

(8) Replaced loan plus replacement loan ((3)+(6)):	$16,000

The amount in (8) does not exceed the amount in (2), so IRC §72(p)(2) is not violated. The replaced loan is treated as repaid as of date of replacement loan.

The plan could have made a separate loan to Will in the amount of $10,000, assuming the plan permits more than one loan to be outstanding at a time. A new loan of $10,000 plus an outstanding loan balance of $6,000 would have equaled Will's maximum loan limit on June 1, 2019, which was $16,000. Will could then have used $6,000 of the proceeds from the second loan to pay off the balance on the first loan. The net effect of this alternative approach is the same as the refinancing example, illustrating why the IRC §72(p) regulations approve of the refinancing transaction. By disbursing an additional $4,000 to Will, treating a new loan of $10,000 to have started on June 1, 2019, and treating the first loan as fully paid, the plan is simply consolidating steps.

EXAMPLE 10-18. Loan Limit Would be Exceeded if Replacement Loan were Added to Outstanding Balance of Replaced Loan. Let us modify the prior EXAMPLE 10-17 slightly. Suppose Will's vested account balance as of June 1, 2019, is only $26,000, because of market fluctuations on his non-loan investments in his account. Will could not have two loans outstanding that total $16,000, because his maximum loan limit is only $13,000. Therefore, under the regulations, the plan cannot treat Will as receiving a second loan for $10,000, and using $6,000 of the proceeds from the second loan to retire the first loan, as suggested in the prior **EXAMPLE 10-17**. What options are available here?

Option #1— separate loans (i.e., no refinancing). Make a separate loan for $4,000 (rather than for $10,000), which is the additional cash that Will needs. The origination date of the separate loan is June 1, 2019. Will continues to amortize his original loan over its remaining term (ending November 30, 2022), which has a balance of $6,000 at this time, and he starts a new amortization period on the second loan of $4,000, which would have a separate repayment term that could end as late as May 31, 2024 (i.e., five years after the origination date). This option is available only if the plan permits Will to have more than one loan outstanding at a time. Because the original loan is not being replaced by the second loan, the plan simply adds the outstanding balance of the first loan to the amount of the second loan to determine if the maximum loan limits are satisfied, using Will’s vested account balance at the time of the second loan to make such determination.

Option #2—refinancing of the original loan with original repayment term. Another option is to consolidate Will's loans into a single loan of $10,000 as of June 1, 2019, through a refinancing transaction. The replacement loan is for $10,000, but only $4,000 is disbursed to Will because the other $6,000 is used to pay off the original loan. However, the repayment term of the replacement loan ends November 30, 2022, which is the same date as the original loan (and the latest permissible term for a loan originating on December 1, 2017, that was not eligible for the principal residence exception nor the military leave exception).

Because the term of the replacement loan is not later than the latest permissible term of the replaced loan, the plan does not treat the replaced loan as outstanding at the time of the replacement loan for purposes of IRC §72(p). The “sum of” rule for replacement loans applies only if the term of the replacement loan ends later than the latest permissible term of the replaced loan. When the loan repayment term is equal to that of the replaced loan, the plan looks only at the replacement loan to determine if the maximum loan limitations have been exceeded. A loan of $10,000 does not exceed Will’s loan limit of $13,000, so IRC §72(p) is not violated. In addition, the replacement loan has a repayment term that does not exceed the five-year rule and the amortization schedule satisfies the requirements of IRC §72.

After the refinancing transaction, Will’s loan payments will be greater because he is amortizing a greater amount over the remainder of the term of the replaced loan.

Option #3—refinancing of the original loan with a new repayment term that amortizes the original loan within its original term. Under this option, the plan disburses $4,000 to Will and consolidates the first loan and the second loan into a refinanced loan for $10,000, as under Option #2, effective June 1, 2019. The difference from Option #2 is

that, instead of having the $10,000 loan fully amortized by November 30, 2022 (as under Option #2), the new loan has a full five-year repayment term that ends May 31, 2022. However, the amortization schedule is structured so that at least $6,000 of the principal (which was the loan balance on the replaced loan at the time of the refinancing) is amortized by the original term of the replaced loan (i.e., November 30, 2022), and the difference is amortized on a level basis during the new five-year term.

This would be accomplished by having Will's payments through November 30, 2022, equal the payments under the replaced loan (as adjusted, if necessary, to reflect a change in the applicable interest rate under the refinanced loan) plus an additional amount needed to amortize the additional $4,000 over a five-year period starting June 1, 2019. This will repay the $6,000 remaining from the original loan within its original five-year term, and the payments from December 1, 2022, through May 31, 2024, equal only the amount needed to finish amortizing the additional $4,000.

This actually has the same economic effect as Option #1, except the payments are structured under a single loan, rather than under separate loans.

Applying the refinancing rules when the $50,000 limit is an issue. When the loan amounts involved are high enough that the $50,000 limit becomes an issue, the refinancing transaction must take into account the effect of the 12-month lookback to the highest outstanding balance. The difference between the highest outstanding balance of the replaced loan during the last 12 months preceding the refinancing transaction and the outstanding balance of the replaced loan at the time of the refinancing results in a reduction of the $50,000 limit. Therefore, any increase in the net principal amount under the replacement loan must not cause that reduced limit to be exceeded. In addition, if the term of the replacement loan will extend beyond the term of the replaced loan, the approach discussed above and illustrated in Option #2 of EXAMPLE 10-18 is recommended. Failure to use that approach will result in the outstanding balance of the replaced loan to be added to the total amount of the replacement loan, surely resulting in a violation of the $50,000 limit. The following examples, taken from the Treasury regulations illustrate this point.[28]

EXAMPLE 10-19. Sum of Outstanding Balance on Replaced Loan and Total Amount of Replacement Loan Exceeds the $50,000 Limit. A participant borrows $40,000 on January 1, 2018. The participant's vested account balance exceeds $100,000, and there are no other existing loans (nor any outstanding loan balances within the last 12 months). The loan provides for 20 quarterly installments (i.e., five-year term) of $2,491 each, based on a reasonable interest rate determined on January 1, 2018. The loan term ends December 31, 2022. On January 1, 2019, when the outstanding balance of the 2018 loan is $33,322, the loan is refinanced and is replaced by a new loan of $40,000. A new amortization schedule is established, providing for 20 quarterly installments of $2,491 each, with a term ending December 31, 2023.

The replacement loan uses the same interest rate as the replaced loan, based on the assumption that the original interest rate is still a reasonable interest rate on January 1,

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2019. Because the replacement loan has a term that ends later than the latest permissible term of the replaced loan, the plan must apply the maximum loan limits by treating both loans as outstanding on January 1, 2019.

The amount of the replacement loan is $40,000 and the outstanding balance of the replaced loan is $33,322, resulting in a total loan amount of $73,322. In addition, the $50,000 loan limit is reduced to $43,322. This is determined by taking the participant's highest outstanding loan balance as of the 12-month period preceding January 1, 2019 (i.e., $40,000 borrowed on January 1, 2018), and subtracting the outstanding balance on January 1, 2019 (i.e., $33,322). The difference, which is $6,678, is subtracted from $50,000, to determine the adjusted maximum loan limit of $43,322. Thus, the refinancing results in a taxable deemed distribution of $30,000 (i.e., $73,322 minus $43,322).[29]

EXAMPLE 10-20. Alternative Method of Refinancing that Would Not Result in a Deemed Distribution. To avoid the tax consequences in the prior EXAMPLE 10-19, the replacement loan could provide for the first 16 quarterly installments to equal $2,907, and the last four quarterly installments (i.e., during 2022) to equal $416. This is based on the originally scheduled installment payments under the replaced loan ($2,491 per quarter) plus the amount needed to amortize the difference (i.e., $40,000 minus $33,322, or $6,678) over the five-year term of the replacement loan (an addition $416 per quarter).

The sum of these two components ($2,907) applies for the remainder of the term under the replaced loan (i.e., through December 31, 2022), and only the second component ($416) applies for the additional period under the replacement loan (i.e., 2022). In this case, only the $40,000 replacement loan is taken into account to determine if IRC §72(p)(2) is satisfied, which is not in excess of the adjusted $50,000 limit of $43,322.[30]

Modification of Payment Frequency

Suppose a participant loan is set up with monthly amortization payments. Could the loan be renegotiated to modify the frequency of payment, so long as the payment term does not exceed the requirements of IRC §72(p)? The IRS permitted such a modification where the repayment of the loan was done through payroll deductions and the payroll periods changed. The loans were transferred to the plan of a new employer, pursuant to an acquisition of the old employer. The new employer had a different payroll frequency than the old employer had, and the plan administrator of the transferee plan wanted to revise the amortization schedule to match the new payroll frequency. The IRS also ruled that this type of modification is not treated as creating a new loan, so the IRC §72(p) limits and the adequate security requirements would not have to be redetermined. Modifications that change the frequency of the loan should be noncontroversial in most cases, especially when the term or amount of the loan is not being modified, and the modification relates to some corresponding business issues.[31]

[29] Treas. Reg. §1.72(p)-1, Q&A-20(b), Example 1.
[30] Treas. Reg. §1.72(p)-1, Q&A-20(a)(2).
[31] PLR 9729042.

Even under the Treasury regulations, a renegotiation of the payment frequency, without extending the term or increasing the outstanding balance of the loan, would not require that both the replaced loan and the replacement loan be treated as outstanding on the loan date, because the replacement loan would have the same term as the replaced loan. However, if the loan were treated as a new loan because of the change in the frequency of payments, it would necessitate reestablishing the reasonableness of the interest rate, as well as the value of the participant's vested account balance for purposes of applying the 50 percent loan limit. It should be a reasonable interpretation of IRC §72(p), however, that, if all aspects of the loan remain the same with the sole exception of changing the frequency of payment due to a modified payroll period, treatment of the additional funding as a new loan would not be necessary.

Renegotiating the Interest Rate

It should be permissible to renegotiate the interest rate on a loan, so long as the reasonableness of the interest rate is tested as of the date of renegotiation. Although this will change the amount of each amortization payment that is made subsequent to the renegotiation, the IRS should not challenge the plan's compliance with the level amortization requirement, so long as payments made after the renegotiation of the interest rate are level. There should be no need to take into account the outstanding balance of the replaced loan, so long as the term of the replacement loan is not longer than the latest permissible term of the replaced loan. A plan may refinance a loan for the sole purpose of establishing a different interest rate and, if the replaced loan was not for the latest permissible term, to extend the amortization period to at least the latest permissible term of the replaced loan.[32] This type of refinancing might be especially helpful in preventing default on a loan where the payments have become burdensome to the employee due to changed financial circumstances. Any renegotiation of interest rates should be authorized specifically by the plan's loan provision (or separate written loan policy), and must be available on a nondiscriminatory basis.

FAILURE TO SATISFY LOAN REPAYMENT TERMS

If a participant loan, by its terms, fails to satisfy the maximum term requirement or the amortization frequency requirement under IRC §72(p), the entire loan is taxable, including a loan that is within the maximum loan amount limit.[33]

EXAMPLE 10-21. Maximum Payment Term Exceeded. A participant's vested account balance is $30,000. The 50 percent loan limit is $15,000. A loan for $11,000 is made to the participant. However, the terms of the loan provide for repayment over a seven-year period and the principal residence exception is not available. Because the five-year repayment term limit is exceeded in the loan documentation, the entire $11,000 is taxable as a deemed distribution at its inception, even though it is within the 50 percent loan limit.

[32] Treas. Reg. §1.72(p)-1, A-20.
[33] Treas. Reg. §1.72(p)-1, A-4.

EXAMPLE 10-22. Minimum Frequency of Amortization Not Satisfied. A participant loan is made for $38,000. This is less than 50 percent of the participant's vested account balance. The term of the loan is five years, payable in five level payments, one due on each anniversary of the loan. The entire

$38,000 is taxable as a deemed distribution at its inception, because the loan documentation does not provide for a payment frequency that is at least quarterly.

PRINCIPAL RESIDENCE LOAN EXCEPTION

If the participant loan constitutes a home loan, the repayment period can exceed five years. A home loan is a loan that is used to acquire a dwelling which, within a reasonable time, will be used as the participant's principal residence.[34] The principal residence exception allows for a repayment period over any reasonable period. Note that the level amortization requirement continues to apply to a home loan.

The tracing rules established under IRC §163(h)(3)(B) (which relates to the personal deduction of interest on residence loans) will be applied by the IRS to determine whether the loan is for the acquisition of a principal residence.[35] A refinancing does not qualify as a principal residence loan. However, a plan loan to repay a third party may qualify if the tracing rules would treat the loan as for the acquisition of a principal residence.

EXAMPLE 10-23. Principal Residence Loan. On August 1, 2016, a participant acquires a principal residence and pays a portion of the purchase price with a $50,000 bank loan. On September 1, 2018, the plan lends $50,000 to the participant, payable in level monthly installments over 15 years. The participant repays the bank loan with the loan from the plan. Taking into account the tracing rules of IRC §163(h)(3)(B), the loan satisfies the principal residence exception.

If You're Curious …

Construction of Principal Residence

The regulations do not shed light on whether a loan for the cost of constructing the principal residence could qualify as a principal residence loan. In other words, is construction an acquisition? The tracing rules under IRC §163(h)(3)(B) may help here, but it is not clear. A conservative approach is not to treat a construction loan as a principal residence loan until guidance is issued on this subject, or to request a private letter ruling on the issue. The amendments made to IRC §72(p) in 1986 support an

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[34] IRC §72(p)(2)(B)(ii).

[35] Treas. Reg. §1.72(p)-1, Q&A-7, IRS Notice 88-74, 1988-1 C.B. 385.

argument that a loan for construction of a residence is not included in the definition of a principal residence loan.

EFFECT OF DEFAULT ON LOAN PAYMENTS

When a participant defaults on his or her loan repayments (i.e., defaulted loan), a deemed distribution of the entire unpaid loan balance results because the repayment requirements of IRC §72(p) are no longer being satisfied.[36] The unpaid balance includes interest that is accrued through the date of default (but not interest accrued after that date). This rule recognizes that the repayment requirements of IRC §72(p) are operational requirements, as well as form requirements. Once a required installment is not paid, the Treasury treats the loan as falling out of compliance with the repayment rules.

Cure Period for Default

The plan administrator may allow for a cure period before it treats the unpaid balance as a deemed distribution under IRC §72(p). The cure period may not extend beyond the last day of the calendar quarter following the calendar quarter in which the missed installment payment was due.[37]

EXAMPLE 10-24. Maximum Cure Period. A participant loan is repayable in monthly installments of $100. The participant does not make the May 1 payment. The calendar quarter following May 1 is July 1 through September 30. The plan administrator may provide a cure period lasting no longer than September 30 before the outstanding loan balance must be treated as a deemed distribution.

EXAMPLE 10-25. Cure Period is Shorter than Maximum Allowed in Regulations. A participant is making monthly installments on a loan from the plan. The participant misses the payment due August 31 and subsequent monthly payments. The plan provides a three-month cure period. The cure period for the August 31 payment ends November 30. The amount is not paid by then. The deemed distribution is the participant's outstanding loan balance including interest accrued through November 30.[38]

Suppose, instead, that the plan in EXAMPLE 10-25 used the maximum cure period permitted by law. In that case, the cure period would not end until December 31, so there would be an additional month of accrued interest. A longer cure period means that more interest may accrue before the default actually occurs, and that increases the taxable deemed distribution. A question often arises as to whether the cure period can apply to the last loan payment, even if that payment is due at the end of the maximum repayment period (usually five years) permitted under IRC §72(p). According to the IRS in a Q&A session conducted with the American Bar Association on May 9, 2003, the

[36] Treas. Reg. §1.72(p)-1, Q&A-10.
[37] Treas. Reg. §1.72(p)-1, Q&A-10(a).
[38] Treas. Reg. §1.72(p)-1, Q&A-10(c).

IRS says that the cure period applies to the last loan payment.[39] Therefore, a five-year loan is considered to be paid on a timely basis if the final payment is made within the cure period following the payment due date.

Payroll Withholding for Loan Payments Can Reduce Incidents of Default

To minimize the chances of default, a plan may require that participant loans to current employees be conditioned upon a payroll withholding agreement. Under the agreement, the loan payments would be deducted directly from the employee's paycheck.

Sometimes the payroll department (or payroll service provider) fails to take the steps necessary to activate deductions for loan repayments in accordance with the amortization schedule applicable to the participant’s loan. Technically, the loan is out of compliance and the participant has missed payments. This could lead to default, resulting in a deemed distribution under IRC §72(p). How could this situation be remedied? The length of time that this goes on can be an issue as to whether the employer takes the position that there is some shared responsibility here by the affected participants, because they should have seen that loan payments were not being deducted. This may be a good issue to resolve through EPCRS (which provides procedures for correcting an employer-caused default, through a VCP filing or SCP in some cases).[40]

Possible solutions under EPCRS to a defaulted loan that is caused by employer error include:

- Arrange immediate payment by the participant of the missed payments in a lump sum and restart the regular loan payments for the balance of the repayment period; or
- Re-amortize the loan for the remainder of the maximum repayment period based on the loan origination date.

In addition, if the late loan payments are within the cure period, the employee can make the proper amortized payments, which will be considered to be cures for the previously late payments (and this can be continued until the end of the loan period).

The EPCRS procedures acknowledge that it is inappropriate for the participant to bear the cost of the employer’s error. As such, the procedure permits the plan sponsor to pay any excess interest that has accrued through its inaction. But the procedure further clarifies that it is the IRS’s position that the actual loan and the properly accrued interest must be repaid by the participant.

Subsequent Loans Subject to Special Conditions

Additional requirements apply to a loan that is made after a deemed distribution but before the deemed distributed loan is repaid (or offset). If these conditions are not satisfied, the subsequent

[39] Q&A session conducted with the American Bar Association on May 9, 2003, Q&A-1.
[40] Rev. Proc. 2019-19.

loan is treated, in its entirety, as a deemed distribution under IRC §72(p).[41] To comply with these rules, one of the following conditions must be met:

- repayments on the subsequent loan are made under a payroll withholding arrangement that is enforceable under applicable law; or
- the plan receives adequate security from the participant that is in addition to the participant's accrued benefit under the plan (i.e., the plan obtains other collateral for the loan).

The payroll withholding arrangement may be revocable but, if the participant later revokes the arrangement, the outstanding balance of the loan is deemed distributed at that time. Similarly, if the additional collateral is no longer in force before the subsequent loan is repaid, the outstanding balance of the loan becomes a deemed distribution.

SUSPENSION OF PAYMENTS FOR LEAVE OF ABSENCE

The repayment requirements are not violated if payments are suspended for up to one year because of a leave of absence.[42] The participant must be on leave-without-pay or the rate of pay (after income and employment tax withholding) during the leave period must be less than the amount of the installment payments required under the terms of the loan.

When a loan is properly suspended during a leave of absence, the deemed distribution rules will not apply during such suspension, even though the quarterly amortization requirements are not being satisfied. As long as repayments are resumed in accordance with the rules discussed in this section, the participant is not considered to be in violation of the repayment rules, and no tax consequences under IRC §72(p) are incurred.

Repayment Requirements After Leave Ends

When the leave ends (or after one year, if earlier) the loan (including interest that accrues during the leave of absence) must be repaid by the latest date permitted under the maximum repayment rules (i.e., five years from the date of the original loan, unless the loan is a residence loan).[43] By referencing to the latest date, as opposed to the original repayment date, the IRS is allowing the plan to extend the term of the loan if the original loan term was not equal to the statutory maximum. When payments resume, the installment payments may be adjusted for the remaining term to cover the missed payments (i.e., the loan may be re-amortized over the remaining period), or the same payment amount may resume. If the same payment amount resumes, then a balloon payment will usually be due at the end of the term.

EXAMPLE 10-26. Five-year Loan Term; 12-month Leave of Absence. A participant borrows $40,000 payable over five years in monthly installments of $825. After making nine monthly payments, the participant commences an unpaid leave of absence that lasts 12 months. Loan payments are suspended during the absence. At the end of the absence, the participant resumes monthly payments.

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[41] Treas. Reg. §1.72(p)-1, Q&A-19(b)(2).
[42] Treas. Reg. §1.72(p)-1, Q&A-9.
[43] Treas. Reg. §1.72(p)-1, Q&A-9(a).

The monthly loan payments are adjusted to $1,130 so that the entire balance is repaid at the end of the original five-year loan term.

Alternatively, the participant may be allowed to continue making monthly loan payments of $825 and, at the end of the loan term, repay the remaining balance, which is now a balloon payment. Note in this example that the loan term is not extended by the absence period; only the manner of amortizing the loan is modified. Because the original loan term was for five years, which is the maximum time allowed under IRC §72(p), the plan could not extend the repayment deadline in this example.

EXAMPLE 10-27. Loan Period was Less than the Latest Permissible Term: Unadjusted Payments Resume and Continue Beyond Original Loan Term. Oliver receives a loan from his employer's 401(k) plan on August 1, 2017. The loan payments are $250 per month over a period of three years, which ends July 31, 2020.

On February 1, 2018, Oliver takes a six-month unpaid leave. The plan suspends his monthly payments on the loan. On August 1, 2018, he resumes making monthly payments of $250. The plan adds six months (i.e., the leave period) to the end of the original loan term. With the extension, Oliver will continue to make $250 monthly payments until January 31, 2021, rather than until July 31, 2020.

The payment due on January 31, 2021, will include an unpaid balance due to Oliver's failure to pay any interest on the loan during the leave of absence. This approach satisfies the regulations because the loan is repaid no later than the latest date permitted under IRC §72(p), which would have been July 31, 2022, and the loan payments after the leave ends are no less than the payments required under the terms of the loan.

Leaves That Continue Beyond Maximum Loan Term

Suppose the loan has a five-year term, and the participant commences an unpaid leave of absence within 12 months from the end of the loan term. Because the regulations state that repayment of the loan after the leave cannot be later than the latest date permitted under IRC §72(p), a leave of absence that continues beyond the end of the five-year term apparently would not be eligible for the regulatory relief. Installment payments only for the portion of the leave of absence that occurs before the end of the five-year term could be suspended. There is no rule that permits the plan to tack on an additional repayment period to the five-year maximum term allowed under IRC §72(p) due to a normal leave of absence.

EXAMPLE 10-28. Suspension of Loan Payments on Leave of Absence. Sandy receives a loan from her employer’s profit-sharing plan on July 1, 2015. The loan term is for five years, ending June 30, 2020. On January 1, 2020, Sandy

commences a 12-month unpaid leave of absence. For the period January 1 through June 30, 2020, the plan may suspend the loan payments. However, Sandy must repay the remaining balance on the loan by June 30, 2020, or the plan will violate the five-year maximum loan period, and any balance remaining as of June 30, 2020, will be a deemed distribution to Sandy. A refinancing transaction that satisfies the requirements discussed above may be a viable alternative here, if Sandy does not have the financial means to pay the balance on the loan and wants to avoid adverse tax consequences under IRC §72(p).

Interest During Leave Period Is Not Waived

The suspension-of-payments rule does not waive interest on the loan during the leave of absence period. Remember, participant loans must bear a reasonable rate of interest, and zero interest during a leave period would not be reasonable. If the amounts of the loan repayment installments are not adjusted when the participant returns, there will be principal due at the end of the original loan term because, due to the nonpayment of interest during the leave of absence, more of the payments are going to interest than originally projected in the amortization schedule. A balloon payment will be required at the end of the loan term. If the original loan repayment period was not the maximum, the plan may allow the payments to continue beyond the end of the original term up to the maximum term.

Refinancing Transaction Might Be Another Alternative

The rules above assume the original loan is being continued after the leave period. Another alternative might be to replace (i.e., pay off) the loan after the suspension period ends through a refinancing transaction, where the participant might be able to start a new five-year term with respect to the replacement loan.

MILITARY SERVICE PERIODS

IRC §414(u)(4) permits a plan to suspend the obligation to repay a participant loan for any part of any period during which the employee is performing military services, even if the service is not qualified military service under the Uniformed Services Employment and Reemployment Rights Act of 1994. Suspensions due to military service do not have to satisfy the leave-of-absence restrictions described above.[44]

Unlike the normal leave of absence rule described above, a suspension due to military service may exceed one year.

When a loan is properly suspended during a military service leave period, the deemed distribution rules will not apply during such suspension, even though the quarterly amortization requirements are not being satisfied. So long as repayments are resumed in accordance with the rules discussed

[44] Treas. Reg. §1.72(p)-1, Q&A-9(b).

in this section, the participant is not considered to be in violation of the repayment rules, and no tax consequences under IRC §72(p) are incurred.

To satisfy the loan repayment requirements, loan repayments must resume upon completion of the military service, and the loan must be repaid in full (including interest that accrues during the period of military service) by amortization in substantially level payments over a period that ends not later than the latest permissible term of the loan. For this purpose, the latest permissible term is the latest date permitted under IRC §72(p) (i.e., five years from the loan initiation date, unless it is a principal residence loan) plus the period of the military service.[45] In other words, an individual on military leave does get tacking (i.e., the addition) of his or her service period for purposes of the maximum permitted loan repayment term.

For example, if the original loan term ends June 30, 2018 (five years after the loan was taken) and the borrower performs a two-year military service period, opting to suspend the loan during that original loan term, the loan must be repaid in full by June 30, 2020. Thus, the recalculated term may extend beyond five years from the original date of the loan. This is different from the rule for other leaves of absence, in which the loan may be extended only if the original term was less than the maximum period allowed under IRC §72(p).

After a suspension during a military leave, the resumed payments may be the same as they were before the military service period began, resulting in a balloon payment of the remaining balance due (caused by the accrual of interest during the period of military service) at the end of the repayment period. Alternatively, the amount of the payments may be increased so that the balance due at the end of the repayment period is either zero or a reduced amount. Note that, if the due date of the original loan was less than the five-year maximum loan period, the amortization following the military service could extend beyond the original repayment date to the date that is equal to the maximum five-year term (after the original loan initiation date) plus the period of military service.

EXAMPLE 10-29. USERRA Leave. On July 1, 2017, a participant borrows $40,000, to be repaid in level monthly installments of $825 each over five years (with the last payment due on June 30, 2022). The participant makes nine monthly payments of $825 each and then commences a two-year military service period, which ends April 2, 2020.

The participant resumes active employment on April 19, 2020, and continues making monthly installments of $825 until June 30, 2024 (i.e., the date that is two years from the original loan payoff date of June 30, 2022), to take into account the period of military service. As of June 30, 2024, the unpaid balance of $6,487 becomes due.

[45] Treas. Reg. §1.72(p)-1, Q&A-9(c).

Alternatively, the monthly installments could be increased to $930 upon the participant's return to civilian life, in order to repay the loan in full by June 30, 2024, without any balloon payment due at that time.

If You're Curious …

Servicemembers Civil Relief Act of 2003 May Result In Reduced Interest

The Servicemembers Civil Relief Act of 2003 (SCRA), which amends and restates the Soldiers' and Sailors' Civil Relief Act of 1940, may result in a reduced interest rate on a participant loan. Like the 1940 Act, the SCRA applies to members of the uniformed services (Army, Navy, Air Force, Marine Corps or Coast Guard) who are on active duty (or, in the case of a member of the National Guard, service under a call to active service for a period of more than 30 consecutive days).[46] Covered military service also includes periods during which the servicemember is absent from duty on account of sickness, wounds, leave or other lawful cause. The protections of the SCRA also extend to the period beginning on the date a member of a reserve component receives orders to report for military service to the date on which the member actually reports for duty.[47] Section 207 of the SCRA outlines the interest rate limitation and procedures for implementing that limitation. Under the interest rate limitation, the plan may not charge interest in excess of 6 percent during the period of military service to a participant covered by the SCRA who provides appropriate notice.

The plan is not obligated to make adjustments to the loan, as required under the SCRA, until notice is received from the servicemember.[48]

If the servicemember provides the required notice no later than 180 days after the military service period ends, the adjustment of the interest rate is effective for the entire period of military service that is covered by the SCRA.[49] Thus, the interest rate relief would be retroactive to the beginning of the military service period. If loan payments have been suspended, the retroactivity would not create any special accounting issues. However, if, at the time notice is given, loan payments reflecting an interest rate greater than 6 percent already had been made for a portion of the military service period, the plan would have to make appropriate adjustments. Although not addressed specifically in the SCRA, appropriate adjustments might include treatment of the excess payment as a prepayment of interest, or the plan could provide the servicemember with a refund of the excess interest paid.

The interest rate relief applies only to participant loan obligations incurred before the military service period started.[50] Thus, if the servicemember were to take a participant

[46] SCRA §101.
[47] SCRA §106.
[48] SCRA §207(b)(1).
[49] SCRA §207(b)(2).
[50] SCRA §207(a)(1).

loan during the military service period, the plan's normal procedures for setting the interest rate would apply.

The interest rate relief obtained under the SCRA must be treated by the plan as a forgiveness of the excess interest.[51] Thus, if loan payments are suspended during the military service period, the remaining obligation on the loan as of the end of such period may not include the amount of interest that was forgiven.

The servicemember is entitled to retain the higher interest rate being charged by the plan. Section 107(a) of the SCRA provides that a servicemember may "waive any of the rights and protections provided by this Act." However, since the obligation with respect to a participant loan would involve "an obligation secured by a mortgage, trust, deed, lien or other security in the nature of a mortgage," because the participant loan is secured by the participant's accrued benefit, the waiver of rights is not effective unless there is a written agreement between the parties (i.e., the participant and the plan) that is executed during or after the servicemember's period of military service.[52] The written agreement must specify the legal instrument to which the waiver applies (i.e., the note executed by the participant with respect to the participant loan). This right to waive relief is important in the context of a participant loan, since the interest rate being paid by the participant, at least under a typical loan transaction with a defined contribution plan, affects the participant's accrued benefit. A lowering of the interest rate to 6 percent would reduce the account balance's rate of return on the investment represented by the loan from the account to the participant.

As under the Soldiers' and Sailors' Civil Relief Act, the creditor may petition a court to retain the higher interest rate if the court determines that the ability of the servicemember to pay interest upon the obligation or liability at a rate in excess of 6 percent per year is not materially affected by reason of the servicemember's military service. It is doubtful that plan administrators will invoke this right; they generally simply reduce the interest rate when a participant properly invokes his or her rights under the SCRA.

PLAN PROVISIONS MUST SPECIFY LOAN REQUIREMENTS

Loans may be made to participants only if the plan contains a provision authorizing the loan, or the plan authorizes the adoption of a separate written loan policy and such policy is adopted by the fiduciary or fiduciaries with authority to do so.[53] Terms and conditions on loans must be consistent with the plan's loan provisions (or separate written loan policy).

DEEMED DISTRIBUTION FOR TAX PURPOSES IF LOAN VIOLATES IRC §72(P)

When a loan (or portion of a loan) becomes taxable because it fails to satisfy the IRC §72(p) rules, the distribution is a deemed distribution for tax purposes. The amount of the deemed distribution is:

- the amount in excess of the loan dollar limits, if an excess loan is made;

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[51] SCRA §207(a)(2).
[52] SCRA §107(a).
[53] DOL Reg. §2550.408b-1(d).

- the amount of the loan if the failure is in the loan's basic structure or the loan violates the IRC §72(p) rules at its inception; or
- the amount of the outstanding loan if the deemed distribution is due to a failure to satisfy the loan repayment rules.

The deemed distribution terminology is to distinguish the transaction from one where the participant is entitled to the disbursement as a distribution of benefits. With a deemed distribution, the participant is taxed as if he or she received a distribution, but he or she still owes the plan the borrowed proceeds because the transaction was a loan, not an actual distribution.

Basic Tax Rules Apply

A deemed distribution is subject to the same tax rules under IRC §72 as an actual distribution from the plan.[54] In this regard, the amount deemed to be distributed is includible in gross income, and is subject to the 10 percent additional income tax on early distributions under IRC §72(t), if the participant is under age 59½ at the time of the deemed distribution. Thus, if a deemed distribution occurs from an account in which the participant has basis, a portion of the deemed distribution is recovery of that basis, which is not includible in income.

The deemed distribution is not an eligible rollover distribution.[55]

Withholding Requirements on Deemed Distributions

The deemed distribution is not an eligible rollover distribution, so the 20 percent mandatory withholding under IRC §3405(c) does not apply. However, if the loan is a deemed distribution from its inception, the 10 percent waivable withholding rules apply to the proceeds of the loan.[56]

When a deemed distribution occurs on a date which is after the loan is made, usually the case in such circumstances, no withholding is required if the deemed distribution is the only distribution being made at that time, even if the participant has not formally elected to waive withholding. If other cash or property is being distributed at the same time as the deemed distribution, then, unless the participant has waived withholding on the deemed distribution, the required withholding would be taken from the cash or other property, to the extent such other cash or property is sufficient to cover the withholding obligation. Generally, the withholding rate on the deemed distribution would be 10 percent, as it is a nonperiodic distribution that is not eligible for rollover.[57]

Plans that Include Designated Roth Contributions

A deemed distribution with respect to a designated Roth account may not be treated as a qualified Roth distribution, even if, at the time of the deemed distribution, the distributee satisfies the five-taxable-year period and the qualified event requirement. Thus, the portion of the deemed

[54] Treas. Reg. §1.72(p)-1, Q&A-11.
[55] See Treas. Reg. §1.402(c)-2, A-4(c).
[56] Treas. Reg. §§1.402(c)-2, Q&A-4, 1.72(p)-1, Q&A-15.
[57] IRC §3405(b).

distribution which represents earnings on designated Roth contributions is includible in gross income.[58]

Form 1099-R Issued for Deemed Distribution

A deemed distribution under IRC §72(p) is reported on Form 1099-R, as if the plan actually made a distribution.[59] The distribution is coded in Box 7 as either a regular distribution, or a distribution that is a premature distribution, depending on whether the participant is under age 59½. Code L is also included in Box 7 to identify the distribution as a deemed distribution under IRC §72(p).

Deemed Distribution is Treated as Distribution for IRC §72 Purposes, But Not for Other Purposes

A deemed distribution is treated as if there has been an actual distribution only for IRC §72 purposes, and not for other purposes.[60]

Because the deemed distribution is treated as if the portion of the participant's accrued benefit represented by the unpaid loan has been distributed, the normal tax rules under IRC §72 apply, the distribution is reported to the IRS like other distributions, and any later offset of the defaulted loan (including accrued interest) is not reported again at the time of the offset.

If You're Curious …

Rules for Which the Loan is Not Treated as an Actual Distribution

Even though a deemed distribution of a loan is treated as a distribution for IRC §72 purposes, it is not treated as an actual distribution for purposes of qualified plan rules under IRC §401, the distribution provisions of IRC §402, the distribution restrictions under IRC §§401(k)(2) and 403(b)(11) or the vesting requirements of Treas. Reg. §1.411(a)-7(d)(5).[61] Let us analyze these issues separately.

Disqualification considerations. A plan is not disqualified merely because a deemed distribution occurs before the plan would be allowed to make actual distributions to the participant. For example, a pension plan (i.e., money purchase plan, target benefit plan or defined benefit plan), pursuant to Treas. Reg. §1.401-1(b)(1), is precluded from making in-service withdrawals to a participant who has not reached normal retirement age. However, a deemed distribution under IRC §72(p) due to a default on a participant loan does not disqualify the pension plan merely because the deemed distribution occurs before normal retirement age. (In fact, it is the prevention of a bona fide distribution when one is not permitted that is the basis for the deemed distribution characterization.)

Account balances or accrued benefits are not reduced by the deemed distribution for purposes of complying with IRC §401, nor is the deemed distribution treated as if the participant received a distribution for purposes of meeting a particular IRC §401

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[58] Treas. Reg. §1.402A-1, Q&A-11.
[59] Treas. Reg. §1.72(p)-1, Q&A-14.
[60] Treas. Reg. §1.72(p)-1, Q&A-12 and Q&A-19(a).
[61] Treas. Reg. §1.72(p)-1, Q&A-12(a).

requirement. For example, the deemed distribution cannot be counted toward satisfying a participant's RMD for a calendar year under IRC §401(a)(9), nor would the account balance (or accrued benefit) be reduced by the deemed distribution to determine the value of the participant's benefit used to calculate RMDs. In addition, the top-heavy rules under IRC §416 would be applied without regard to the deemed distribution. Thus, the top-heavy ratio for the plan would be calculated without reducing the accrued benefit for the deemed distribution, and the deemed distribution would not be treated as a distribution for purposes of calculating the top-heavy ratio. The deemed distribution also would not reduce the value of benefits used to perform certain coverage or nondiscrimination tests that consider accumulated accrued benefits.

Vesting issues. Implied in the reference to IRC §401 is that the minimum vesting standards under IRC §411 are applied without regard to the deemed distribution. However, the regulations clarify that the deemed distribution is not treated as a distribution for purposes of applying the vesting rules that relate to partial distributions under Treas. Reg. §1.411(a)-7(d)(5). Thus, the plan need not keep a separate accounting of the deemed distribution for purposes of determining the participant's vested interest in the plan. The loan is still treated as part of the participant's account balance, to which the participant's vesting percentage is applied accordingly, until there is an actual offset of the loan.

Distribution restrictions under IRC §§401(k) and 403(b). A 401(k) plan is not disqualified merely because a deemed distribution occurs before one of the events listed in IRC §401(k)(2), even if the loan is secured by elective contributions. Similarly, a 403(b) plan is not treated as failing to satisfy the distribution restrictions under IRC §403(b)(11) merely because a deemed distribution occurs with respect to a loan from the plan.

Determination of the Participant's Account Balance After Deemed Distribution

Because the deemed distribution may not be treated as an actual distribution until there is an offset, the value of a participant’s account balance in a defined contribution plan must reflect the continued existence of the loan. If the loan is an earmarked investment in a participant's account under a defined contribution plan, then the entire value of the loan is included in the participant’s account balance. If the loan is a general trust investment in a defined contribution plan, the loan is part of the value of the trust assets from which the values of the account balances of the participants are determined. If the deemed distribution has arisen because of a default on the loan, which is usually the case, the value of the loan must include accrued interest as well, until a loan offset can be made against the participant's account

Effect of Later Offset on the Account Balance

When the offset actually occurs, the account balance will be reduced, and the offset will be treated as an actual distribution. How the account balance is reduced depends on whether the loan investment is an earmarked investment with respect to the account of the participant who received the loan. Under an earmarked investment, the account balance is reduced by the entire value of the loan, assuming the original loan did not exceed the security interest limits under DOL Reg. §2550.408b-1 at the time the loan was made. Under a general trust investment, the entire value of the loan may be offset against the participant's vested account balance (which has been determined by taking into account the participant's allocable share of the trust's loan asset) only if, at the time of the

offset, the value of the loan (due to accrued interest) has not caused the offset amount to exceed the plan's security interest permitted under DOL Reg. §2550.408b-1. In this latter case, it is possible the unpaid loan would exceed the security interest limits, primarily because of increases in the loan asset due to accrued interest if there is a delay between the deemed distribution and the actual offset. This places the other participants at a risk of loss because the plan's failure to collect the full balance on the loan diminishes the value of the other participants' accounts. This is a fiduciary issue surrounding the prohibited transaction exemption and is discussed in more detail below.

OBLIGATION TO REPAY NOT WAIVED BECAUSE OF DEEMED DISTRIBUTION

Because the deemed distribution treatment under IRC §72(p) is solely a tax rule, and is not treated as an actual distribution for other purposes, the deemed distribution does not affect the participant's continued obligation to repay the loan. The loan obligation is not extinguished until the loan is repaid, either by the participant through a resumption of loan payments, or by offset against the participant's accrued benefit, pursuant to the plan's security interest. In fact, there is still a fiduciary requirement to enforce the loan, because ERISA requires the governing documents of the plan be followed (e.g., the written loan provisions or loan policy that is part of the plan), and to protect the benefits of the plan participant.

BASIS GENERATED FROM REPAYMENT OF PREVIOUSLY-TAXED LOAN

If the participant repays a loan after it is deemed distributed, the participant has basis in the plan for the amount that was previously taxed.[62] The basis recovery rules in IRC §72(b), (d) and (e) apply to determine the taxable portion of any subsequent distribution, where loan repayments have been made on a previously-taxed loan. The basis generated with respect to loan payments on a previously-taxed loan includes interest that is paid with those loan payments.[63]

EXAMPLE 10-30. Repayment After Deemed Distribution. In 2014, Rita receives a participant loan in the amount of $15,000. Before the loan is fully repaid, Rita defaults on the loan, resulting in a deemed distribution under IRC §72(p) of $3,000.

Rita resumes payments on the loan sometime after the deemed distribution. Her payments following the deemed distribution totaled $3,800, which includes the $3,000 default amount plus interest included in her remaining loan payments. Rita has $3,800 of basis in the plan attributable to her repayment of the previously-taxed portion of the loan.

[62] Treas. Reg. §1.72(p)-1, Q-19 and Q-21.
[63] Treas. Reg. §1.72(p)-1, Q&A-21.

On February 1, 2020, Rita terminates employment and is paid a lump sum distribution of her vested account balance. The amount distributed is $90,000. The taxable portion of Rita's distribution is $86,200, because the basis of $3,800 generated from the repayments on the previously-taxed loan is not includible in gross income under the basis recovery rules. Also note that, because the taxable amount of $86,200 is part of an eligible rollover distribution, it is subject to the 20 percent withholding rules to the extent it is not directly rolled over.

It is only when repayments are made on the previously-taxed loan that basis is generated. This coordinates with the reporting rules when the loan receivable is offset, because the unpaid loan balance that was deemed distributed is not reported again at the time of the offset. Because the unpaid balance is not reported again, there is no reason to credit basis for the previously-taxed amount.

Although payments on a previously-taxed loan are treated as basis for tax purposes, they are not treated as after-tax employee contributions for purposes of testing the IRC §415 limits nor for purposes of applying the nondiscrimination test under IRC §401(m) (i.e., the ACP test).[64] Loan payments are not annual additions under IRC §415 because they are simply restoring to the plan already accrued benefits that were borrowed by the participant. These benefits were tested under IRC §415 when they accrued.

If You're Curious …

Only Bona Fide Loans Are Subject to IRC §72(p)

These rules apply only if the transaction is a bona fide loan. If there is an express or tacit understanding that a loan will not be repaid or, for any reason, does not create a debtor-creditor relationship, then the amount transferred to the participant is treated as an actual distribution, and is not treated as a loan or a deemed distribution under IRC §72(p).[65] The IRS scrutinizes very carefully any

loan made to a participant who is the owner of the company or a fiduciary of the plan to determine whether a loan had ever been properly established, particularly where no payments are ever made on the loan. By recharacterizing the transaction as an actual distribution, rather than a loan, the qualification of the plan under IRC §401(a) would be in jeopardy if an actual distribution was not authorized by the plan (or permitted by law) at the time of the sham loan.

In *Patrick v. Commissioner*,[66] the Tax Court cites the following factors in determining whether a loan is bona fide:

- existence of a debt instrument (whether notes are prepared or signed contemporaneously with the receipt of funds);
- provisions for security, interest payments and a fixed repayment date;

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[64] Treas. Reg. §1.72(p)-1, Q&A-21(a).
[65] Treas. Reg. §1.72(p)-1, Q&A-17.
[66] 75 T.C.M. 1629 (1998).

- the parties' records evidencing a loan obligation;
- source of repayment and the ability of the participant to repay;
- relationship of the parties (participants' status as an owner or trustee may be evidence of no intention to create debt);
- whether any payment had been made on the loan;
- whether a demand for repayment is made when payments are in default; and
- whether the participant attempts to pay or seek a postponement when he or she is unable to satisfy the loan terms.

FORM 5500 REPORTING REQUIREMENTS ON DEFAULTED LOANS

The government provides explicit instructions on how to report participant loans that have been deemed distributed under IRC §72(p) because of default.

Earmarked Loans From Defined Contribution Plans

The following reporting requirements apply if the loan is treated as a directed investment solely of the participant's individual account (i.e., earmarked loan) and, as of the end of the plan year, the participant is not continuing repayment under the plan. The deemed distribution under IRC §72(p) is reported on line 2g of Schedule H (large plan filers) or Schedule I (small plan filers that are not eligible to file Form 5500-SF). The loan is not reported on Schedule G as a loan that is in default or is uncollectible.

In the year the deemed distribution is reported, the participant loan is included in the beginning-of-the-year assets (column (a) of line one of Schedule H or I) but not in the end-of-the-year assets (column (b) of line one of Schedule H or I). For subsequent years, the participant loan is not reported as part of the plan's assets, unless the participant later resumes repayment of the loan. If repayments resume in a later year, the loan must be restored as an asset in column (b) of line one of Schedule H or Schedule I, and the amount reported on line 2g for the earlier year must be subtracted from the amount otherwise to be reported on line 2g for the year the repayment resumes (which might be a negative number, as a result).

Note that, although an unpaid participant loan might no longer be reflected in the plan's assets for Form 5500 purposes, the loan is still considered to be outstanding for purposes of applying the maximum loan limits to a subsequent loan. In addition, the Form 5500 instructions caution that the loan is also considered outstanding for other purposes, such as the qualification requirements of IRC §401, including the determination of the top-heavy status of the plan under IRC §416.

Loan Offset Incident to Default

If a loan offset occurs (i.e., the unpaid loan is reported as an actual distribution) when it goes into default, the above reporting rules do not apply. Instead, the loan offset is reported as an actual distribution from the trust, and the loan is not reported in the end-of-year assets on Schedule H or I. In addition, once an offset occurs there is no resumption of payments, so there would not be a

situation, as described in the prior paragraph, where the loan asset would be restored to Schedule H or I because repayments have resumed.

If You're Curious …

Reporting Rules for Other Loans

For participant loans that are not earmarked loans under defined contribution plans, including loans under defined benefit plans, a deemed distribution on account of default is not reported in line 2g of Schedule H or I. Instead, the unpaid loan balance, as increased for accrued interest, continues to be reported as a plan asset, both in the beginning-of-the-year asset column and in the end-of-the-year asset column on Schedule H or I, until the loan balance is actually offset. In addition, the loan is reported on Schedule G as a loan that is in default or is uncollectible. In the year of the offset, the loan is reported as an actual distribution from the trust and is not included in the end-of-the-year asset column on the Schedule H or Schedule I submitted with the Form 5500 filed for that year.

OFFSETTING ACCRUED BENEFIT FOLLOWING A LOAN DEFAULT

There are circumstances under which the loan may be repaid through a reduction of the vested accrued benefit, i.e., a loan offset. With a loan offset, the plan is considered to be distributing the unpaid loan receivable, which represents a portion of the participant's vested accrued benefit. The security interest held by the plan authorizes this reduction. A loan offset to satisfy loan repayment is treated as an actual distribution of the participant's benefit, so it may not occur unless an actual distribution is otherwise available to the participant. Also, as an actual distribution, certain tax rules will apply differently than they do with a deemed distribution.

The consent of neither the participant nor the participant's spouse is required before the plan can proceed with offset, so long as the necessary consents to the use of the accrued benefit as security are obtained at the time the loan is made.[67]

Repayment by Loan Offset

An offset may occur because the governing terms of the loan require a repayment of the loan upon the participant's termination of employment or the distribution of the participant's benefit. An offset of the loan upon termination of employment would be permissible under any type of plan, because all plans (including pension plans and 401(k) plans) may permit distribution of benefits following termination of employment. If an event such as termination or severance from employment of employment requires an offset, the loan documents may include a reasonable period (e.g., 30 days) during which the participant can repay the loan before the offset actually occurs for tax purposes. Note that under 2017's Tax Cuts and Jobs Act, if the plan loan offset is

[67] Treas. Reg. §1.401(a)-20, Q&A-24.

due to plan termination or severance from employment, participants have until the due date, including extensions for filing their income tax, to complete a tax-free rollover.

Some commentators recommend that the loan documents provide for an acceleration of the loan when the participant's employment terminates. The idea is that, with the loan accelerated, the plan will no longer need to continue administering the collection of periodic loan payments if the participant does not consent to an immediate distribution following his or her termination of employment. However, not all employers share this philosophy. Some are concerned about the financial hardship this might place on the participant. If a substantial loan gets accelerated, the participant would be forced to come up with the remaining balance on the loan to avoid taxation on the offset. In addition, the tax consequences resulting from the offset could result in a tax liability that creates a significant financial hardship, unless the participant is going to work for a new employer whose qualified plan is willing to accept the loan in a direct rollover transaction.

EXAMPLE 10-31. Lump-sum Distribution Elected After Termination of Employment. Lucinda has an outstanding loan from her employer's profit-sharing plan. The loan payments are current and the unpaid loan balance is $5,000. Consequently, no part of the loan balance has been taxed under the deemed distribution rules of IRC §72(p). Following her termination of employment, Lucinda elects a lump sum distribution of her vested account balance.

The value of her vested account balance is $26,000. This includes a non-loan portion ($21,000) and a loan receivable ($5,000). The amount distributed to Lucinda is $21,000 (i.e., her $26,000 vested account balance reduced by $5,000, reflecting the offset of the loan receivable to repay the outstanding loan balance). However, Lucinda's taxable distribution is $26,000, which includes the loan offset.

EXAMPLE 10-32. Loan Offset Occurs Solely Because of Termination of Employment. Assume, instead, that the terms of the loan provide that upon termination of employment, the vested account balance is reduced by the outstanding balance of the loan in full satisfaction of the loan obligation, regardless of whether non-loan assets are being distributed at that time. Lucinda is not receiving distribution of any other portion of her account balance when the loan offset occurs.

The plan offsets $5,000 from her vested account balance to repay the loan, representing the offset of the loan receivable. Lucinda's taxable distribution is $5,000, which consists solely of the loan offset. No check is actually issued to Lucinda. After the loan offset, Lucinda's account balance reflects only non-loan assets.

EXAMPLE 10-33. Using In-service Withdrawal Provision to Repay Loan by Offset. Lee has an outstanding participant loan from his employer's profit-sharing plan. The plan permits in-service withdrawals after a participant reaches age 50.

Following Lee's 50th birthday, he requests a distribution of $7,000, which equals the unpaid loan balance. Lee requests that the distribution be in the form of a loan offset, to repay the remaining loan balance.

The plan offsets the loan receivable as Lee's distribution, resulting in full repayment of the loan. Lee's taxable distribution is $7,000, which consists solely of the offset. No check is actually issued to Lee. After the distribution, Lee's account balance now reflects only non-loan assets.

Loan Offsets After Loan Default

When a loan goes into default, it is no longer satisfying the repayment requirements of IRC §72(p)(2). The governing terms of the loan must specify when default occurs.[68] If the plan is able to and does foreclose against the vested accrued benefit on account of default (i.e., offsets the loan receivable and makes a corresponding adjustment to the total value of the participant's vested accrued benefit), the offset is treated as an actual distribution of that portion of the participant's benefit.

If You're Curious …

Timing of Offset

The offset can occur simultaneously with the default only if an actual distribution is permitted at the time the default occurs. If an actual distribution is not permitted at the time of default, then the offset will occur at a later date.

EXAMPLE 10-34. Offset Triggered by Default. Chauncey has an outstanding participant loan in the amount of $12,000 from his employer's profit-sharing plan. The loan is amortized on a monthly basis. Chauncey has failed to make loan payments for three months. Under the terms of the loan, Chauncey is in default. The plan provides that upon default, the vested accrued benefit is reduced by the amount in default, pursuant to the plan's security interest. Because the plan is a profit-sharing plan, loan default can be a stated event that permits distribution or offset of the loan. Chauncey's account is reduced by $12,270, representing the unpaid balance of the loan and unpaid interest through the default date. Chauncey's distribution is $12,270, which consists solely of the offset due to his default on the loan. The gross distribution reported on Form 1099-R is $12,270, all of which is taxable, unless a portion of that distribution is attributable to basis (e.g., after-tax employee contributions).

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[68] DOL Reg. §2550.408b-1(d)(2)(vii).

Tax Effect of a Delay Between Default and Loan Offset

If, because of distribution restrictions, there is a delay between the default and the loan offset, the loan obligation continues. In such a case, the default triggers a deemed distribution under IRC §72(p), with the resulting tax consequences described earlier, followed by an actual distribution at a later date, when the loan offset occurs. At the time of the later offset, the previous taxation of the loan under the deemed distribution would be taken into account to determine the tax consequences of the loan offset and the reporting requirements for the later distribution.

EXAMPLE 10-35. Defaulted Loan Offset After Subsequent Termination of Employment. Robin defaults on a participant loan from a money purchase plan. The outstanding balance is $3,000. Pursuant to the deemed distribution rules of IRC §72(p), Robin is taxed on the unpaid balance and a Form 1099-R is issued for that deemed distribution. Her account balance is not reduced by a loan offset, however, because Robin has not terminated employment and no other proper distribution event applies with respect to the money purchase plan. Two years later, Robin terminates employment and elects a distribution of her vested account balance. The distribution will include an offset of the loan receivable. However, the taxable distribution will not include the defaulted loan, because the default was reported as taxable in a prior year as a deemed distribution.

Tax and Plan Accounting Rules Regarding Accrued Interest on a Loan in Default

When a loan is in default, but the offset is delayed, the loan obligation continues. As a continuing obligation, the plan must continue to charge interest on the outstanding loan balance. A failure to charge interest may result in a prohibited transaction because a participant loan must bear a reasonable rate of interest.[69]

Post-default Accrued Interest is Not Taxed

The accrued interest following a loan default is not taxed to the participant when it accrues. In addition, at the time of the offset of the loan receivable, the accrued interest is not reported for tax purposes.[70]

EXAMPLE 10-36. Effect of Post-default Accrued Interest on Loan Taxation. Liz defaults on a participant loan in 2018. Her initial default amount is $7,250, which represents her unpaid principal and interest as of the default date. The initial default amount results in a deemed distribution, pursuant to IRC §72(p), and $7,250 is taxable to Liz in 2018. There is no distribution event that permits a loan offset at that time.

Interest accrues in the amount of $350 for the remainder of 2016, $750 for all of 2019, and $100 in 2020 (through March 10). None of this accrued interest is taxed in 2018,

[69] IRC §4975(d)(1)(D) and Rev. Rul. 89-14, 1989-1 C.B. 633.
[70] Treas. Reg. §1.72(p)-1, Q&A-19, Q&A-21, and Q&A-22.

2019, or 2020. As of March 10, 2020, a distribution event occurs that permits an offset of the loan receivable. The total loan receivable is now $8,450, representing the initial default amount plus the sum of the accrued interest.

The distribution to Liz consists only of the loan receivable, pursuant to a loan offset. The non-loan portion of her accrued benefit remains in the plan. The plan no longer accrues interest after March 10, 2020, because the loan receivable is no longer an asset of the plan due to the loan offset. When the loan receivable is offset, none of that amount is includible in income: not the $7,250 which was previously taxed as part of the deemed distribution, nor the accrued interest of $1,200.

Although the accrued interest is not taxed, the IRS requires that the accrued interest continue to be accumulated as part of the loan receivable.[71] When the loan receivable is later offset against the participant's accrued benefit, the loan obligation is satisfied, and interest no longer accrues.

Accrued interest must be considered part of the outstanding loan balance for purposes of determining whether any subsequent loan exceeds the IRC §72(p) limits.[72] For example, suppose a participant's initial default amount was $5,000. The accrued interest on that amount is $2,000. That means the outstanding loan balance of this participant is $7,000. If the 50 percent limit under IRC §72(p) is $12,000, the maximum new loan amount available would be $5,000.

Accrued Interest is Integral to the Determination of the Total Repayment Obligation

Because the unpaid loan is still an obligation, the accrued interest is necessary to accurately determine the participant's repayment obligation. The plan may be successful in enforcing repayment of the loan, or the participant might voluntarily repay the loan. The additional repayment obligation generated from the accrued interest represents funds the participant can pay to the plan that will not be treated as annual additions under IRC §415 (because they are treated as earnings of the trust with respect to the loan) and can be invested to generate additional trust income for the participant's benefit. In addition, the repayment of the defaulted loan can increase the amount the participant may be able to roll over to another plan, even though the repayments would generate basis.

Accrued Interest Affects Value of Account Balance under Defined Contribution Plan

The accrued interest is part of the value of the participant's total account balance under a defined contribution plan. This would affect a number of issues, including the value of benefits for determining whether the plan is top-heavy and the value of benefits when performing certain coverage or nondiscrimination tests that consider accumulated accrued benefits.

Effect of Accrued Interest on Distributions

[71] Treas. Reg. §1.72(p)-1, Q&A-19.
[72] Treas. Reg. §1.72(p)-1, Q&A-19(b).

> If, in a defined contribution plan, the participant's loan is carried as an earmarked investment for that participant's account (which is usually the case), the accrued interest will have no effect on distributions to other participants. The accrued interest simply increases the value of the loan receivable, which is solely part of that participant's account. When a loan offset occurs, only that participant's account is affected by the loss that occurs when the accrued interest is not repaid. On the other hand, if the participant's loan under a defined contribution plan is carried as a general trust investment, then the accrued interest represents unrealized gains that affect the calculation of other participants' benefits. If another participant takes distribution from the plan when the loan receivable is still outstanding, additional non-loan assets of the plan are being used to satisfy the distribution liability because part of the value of the distribution is reflected by these unrealized gains. It is possible, in this latter case, that the other participants are at risk if there is a significant delay between default and loan offset.

TAX CONSEQUENCES AND REPORTING RULES FOR LOAN OFFSETS

Although for qualification purposes the loan offset is an actual distribution, the loan offset is not necessarily a distribution for tax purposes. The treatment of the offset for tax purposes depends on whether the loan has previously been taxed as a deemed distribution under IRC §72(p). A loan that has been deemed distributed under IRC §72(p), including accrued interest credited after the deemed distribution, is disregarded in applying the IRC §72 tax reporting rules. Thus, when a previously-taxed loan is later offset, the offset amount (including the amount representing accrued interest on a defaulted loan) is not included as part of the gross distribution when the loan offset is made.[73] The prior reporting of the deemed distribution has satisfied the reporting obligations on that loan receivable. This provides consistency with the requirement not to credit basis for the deemed distribution.[74] Because the loan offset is not being reported as part of the distribution, there is no need to credit the participant with basis to recognize the prior taxation of the loan.

On the other hand, if a loan offset occurs on a loan that has not previously been reported as a deemed distribution [i.e., the offset event is triggering taxation of the loan, rather than a prior deemed distribution under IRC §72(p)], then the offset is reported as part of the gross distribution. If the participant is under age 59½, the 10 percent tax on early distributions under IRC §72(t) will apply to the portion includible in gross income.

If there is an offset with respect to a designated Roth account, the plan will treat the portion of the outstanding loan that is attributable to the designated Roth account as a distribution from the designated Roth account for tax purposes. To the extent there has not been previous taxation under the deemed distribution rules, the offset distribution from the designated Roth account will be subject to the applicable tax treatment (depending on whether it is a qualified or nonqualified Roth

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[73] Treas. Reg. §1.72(p)-1, Q&A-19(a).
[74] Treas. Reg. §1.72(p)-1, Q&A-19.

distribution). Note that when there is a deemed distribution rather than an offset, the resulting distribution is always characterized as a nonqualified Roth distribution.

APPLICATION OF ROLLOVER RULES TO LOANS

If the loan offset, or the distribution of which the loan offset is a part, satisfies the definition of an eligible rollover distribution under IRC §402(c), the participant may defer taxation by making a timely rollover. A loan offset of a previously-taxed loan, under the deemed distribution rules, is eligible for rollover.

The participant can complete the rollover of the offset distribution by contributing to an IRA (or to another eligible retirement plan) cash equal to the amount of the loan offset within 60 days after the date of the offset. Note that under 2017's Tax Cuts and Jobs Act, if the plan loan offset is due to plan termination or severance from employment, participants have until the due date, including extensions for filing their income tax, to complete a tax-free rollover. This contribution may be made in addition to any direct rollover of the non-offset portion of the eligible rollover distribution.[75]

EXAMPLE 10-37. Cash Rolled Over to Replace Offset Amount. Bonnie has requested a lump sum distribution from her employer's profit-sharing plan. Her vested account balance is $80,000, which includes a loan receivable of $10,000. The entire $80,000 is taxable because Bonnie does not have any basis in the plan. Wanting to defer taxation on the entire $80,000, she elects a direct rollover.

The plan offsets the loan receivable ($10,000) from the $80,000, and directly rolls over $70,000 to Bonnie's IRA. To complete the rollover of the $10,000 representing the offset, Bonnie may transfer $10,000 in cash to the IRA. She may take the cash from her personal investment account. The $10,000 rollover must occur within the 60-day rollover period.

EXAMPLE 10-38. Rollover of Loan Offset Amount Not Completed. Suppose, in **EXAMPLE 10-37**, that Bonnie does not make the $10,000 rollover, but the direct rollover of $70,000 is made. Bonnie is taxed on $10,000, which is the portion of the distribution not rolled over.

On the other hand, if the recipient plan of the rollover is another eligible retirement plan, rather than an IRA, the note representing the participant loan may be directly rolled over, avoiding the triggering of a loan offset.[76] A direct rollover of the loan to an IRA is not possible, because it is a

[75] Treas. Reg. §1.401(a)(31)-1, A-16.
[76] Treas. Reg. §1.401(a)(31)-1, A-16.

prohibited transaction for an IRA to lend money to the IRA owner. Such a loan causes the entire IRA to lose its tax-exempt status.

EXAMPLE 10-39. Direct Rollover of Note. Suppose, in **EXAMPLE 10-37**, that Bonnie is working for a new employer and she participates in the employer's qualified plan. The plan accepts rollovers and also provides for a participant loan program. Bonnie elects a direct rollover of $80,000 to the new plan. Because the recipient plan is a qualified plan, the direct rollover may include the outstanding loan of $10,000. Bonnie will continue to repay the $10,000 note under the recipient plan. In other words, the loan receivable now becomes an asset of the recipient plan and is part of Bonnie’s accrued benefit in that plan.

EXAMPLE 10-40. Loan Offset is Only Distribution. Continuing with this scenario, suppose Bonnie is not electing a lump-sum distribution. Instead, the plan is offsetting $10,000 against her account balance because of Bonnie’s default on the loan.

The profit-sharing plan provides for immediate foreclosure upon default, which is an actual distribution of the loan balance. There has not been any previous taxation of the loan because the loan, until default, satisfied the IRC §72(p) requirements. Bonnie has a taxable distribution of $10,000, but the plan is not actually distributing any cash. The entire distribution consists of the loan offset.

The plan need not offer Bonnie any direct rollover option. However, she may roll over $10,000 in cash to an IRA to defer taxation on the offset distribution. Alternatively, Bonnie could pay the $10,000 to the plan to avoid the default on the loan. Because the loan offset in this example occurs at the same time as the default, there is no separate deemed distribution reported. Instead, the cashless distribution is reported as an actual distribution of a loan receivable (i.e., loan offset) and code L is not included on Form 1099-R.

If You’re Curious …

Effect of Automatic Rollover Rules On Loan Rollovers

IRC §401(a)(31)(B) requires a plan to directly roll over to an IRA any involuntary cash-out distribution with a value in excess of $1,000, in the absence of an affirmative election by the participant.[77] These automatic rollover rules do not apply to loan offsets.[78]

Loan Offset Is the Only Distribution Being Made

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[77] Notice 2005-5, Q&A-1 and Q&A-2.

[78] Notice 2005-5, Q&A-1.

Suppose an event occurs that permits the plan to offset the outstanding loan balance (e.g., termination of employment requires the loan balance to become due and payable and the participant has not made the payment in a timely fashion). In this case, the distribution is entirely a cashless one (i.e., an offset), because it represents the outstanding loan balance that remains unpaid at the time of the offset, and no other part of the accrued benefit is being paid at that time. In this scenario, the automatic rollover rules under IRC §401(a)(31)(B) do not apply.

Other Distribution Made Simultaneously With the Loan Offset and Total Vested Interest Exceeds $5,000

Suppose, that at the same time as the offset occurs, the balance of the participant's vested accrued benefit is being distributed. If the total vested interest, including the outstanding loan, exceeds $5,000, then the total distribution could not be made without the consent of the participant (and the spouse, if the QJSA rules apply). Because the total vested interest being distributed (i.e., offset and non-offset portion) exceeds $5,000, the rules under IRC §401(a)(31)(B) would not apply.[79]

If the participant's vested interest exceeds $5,000, and the participant will not consent to distribution, the plan can still proceed with the loan offset without such consent. If, after the loan offset, the vested interest is now $5,000 or less, then the remainder of the vested interest could be distributed as an involuntary cash-out distribution, and the automatic rollover rules under IRC §401(a)(31)(B) would apply to that distribution.

Other Distribution Made Simultaneously With the Loan and Total Vested Interest Does Not Exceed $5,000

Because the involuntary cash-out limit of $5,000 is not exceeded, the plan will be able to pay the total vested interest (offset portion and non-offset portion) simultaneously. As an involuntary cash-out of $5,000 or less, the automatic rollover rules under IRC §401(a)(31)(B) will apply. The loan offset portion of the involuntary cash-out distribution would not be subject to the automatic rollover rule, but the remainder would have to be rolled to an IRA unless the participant has affirmatively elected cash.

If the total amount is $1,000 or less, the plan would not be required to apply the automatic rollover rules. However, suppose the non-offset portion does not exceed $1,000, but the total amount of the involuntary cash-out distribution is more than $1,000 when the loan offset is taken into account.

Because the loan offset is exempt from the automatic rollover rule, it should be reasonable to assume that the automatic rollover rule does not apply, on the basis that the amount that would be subject to the automatic rollover (i.e., the non-offset portion) does not exceed $1,000. The IRS has not spoken directly to this issue. To avoid the issue, the plan could instead complete the transaction as two separate distributions. First, the loan offset could be executed, and then a subsequent distribution of the remainder of the vested interest would follow which, if it were less than $1,000, would not have to be subject to the automatic rollover rule.

[79] Notice 2005-5, Q&A-1.

APPLICATION OF WITHHOLDING RULES

The IRS provides special rules for applying the 20 percent withholding requirement to eligible rollover distributions that include a loan offset.[80]

Maximum Withholding Obligation Will Not Exceed Non-Loan-Offset Portion

The amount of withholding required is the lesser of 20 percent of the total taxable distribution or the non-loan-offset portion of the taxable distribution. The non-loan-offset portion of the taxable distribution is the total taxable distribution minus the loan offset. The taxable distribution does not include any direct rollover elected by the participant, nor does it include a loan offset of a loan that was previously taxed as a deemed distribution under IRC §72(p).

EXAMPLE 10-41. No Direct Rollover. Curtis terminates employment and elects a lump-sum distribution of his vested account balance. The value of his vested interest at the time of distribution is $60,000, which includes an outstanding loan balance of $15,000. The loan is current and no portion has been previously taxed under the IRC §72(p) deemed distribution rules.

Curtis does not elect a direct rollover of any portion of his distribution. The net distribution to be made to Curtis is $45,000, after the plan offsets the distribution for the outstanding loan balance. However, Curtis will be taxed on the full value of $60,000.

20 percent of the total taxable distribution ($60,000) is $12,000. The non-loan-offset portion of the taxable distribution is $45,000. The required federal income tax withholding is $12,000 because that is the lesser of the two amounts. Therefore, Curtis actually receives a cash distribution of $33,000 ($60,000, less the $15,000 loan offset and the $12,000 of tax withholding).

EXAMPLE 10-42. Direct Rollover of Entire Non-loan-offset Portion of Distribution. Suppose, in the prior EXAMPLE 10-41, that Curtis directs a rollover of $45,000, leaving only the loan offset ($15,000) as the taxable distribution amount. In this case, there is no withholding. The total taxable distribution ($15,000) multiplied by 20 percent is $3,000. The non-loan-offset portion of the taxable distribution is $0. The required federal income tax withholding is the lesser of 20 percent of the total taxable distribution ($3,000) or the non-loan-offset portion of the taxable distribution ($0). The lesser amount is $0, so no withholding is required.

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[80] Treas. Reg. §31.3405(c)-1, A-11.

EXAMPLE 10-43. Part of Non-loan-offset Portion is Not Directly Rolled Over. Suppose, in the prior EXAMPLE 10-41, Curtis directs a rollover of $42,000, leaving a total taxable distribution of $18,000. The non-loan-offset portion of the taxable distribution is only $3,000, because the $18,000 amount is reduced by the $15,000 loan offset. The total taxable amount ($18,000) times 20 percent is $3,600. The non-loan-offset portion of the taxable distribution is $3,000. The required withholding is $3,000, which is the lesser of these two amounts. No cash is distributed to Curtis because the total cash portion of the taxable distribution ($3,000) is transmitted to the IRS for federal income tax withholding.

EXAMPLE 10-44. Loan Previously Taxed as a Deemed Distribution. Let us change the facts one more time. Suppose, in the prior EXAMPLE 10-41, Curtis' loan offset represents a loan that went into default two years earlier and was taxed at that time as a deemed distribution under IRC §72(p). The $15,000 offset also includes accrued interest on that defaulted loan. Now Curtis' gross reportable distribution is only $45,000. Withholding will apply only to that portion of the $45,000 that is not directly rolled over. Note that the $15,000 loan offset is not subject to withholding because it represents nontaxable dollars, since the earlier deemed distribution taxed that loan, and any subsequent interest accrued after the loan was defaulted is not taxed upon the subsequent offset.

Distributions That Are Not Eligible for Rollover

If the loan offset is not part of an eligible rollover distribution (e.g., a loan offset is made in full or partial satisfaction of a distribution that is not eligible for rollover because it represents an RMD or part of a series of substantially equal payments), the same rules apply, except to the extent there is cash or other property being distributed in addition to the loan offset. In this case, the withholding amount would not be determined under the 20 percent rate. Instead, the voluntary withholding rules would apply and the participant could waive the withholding. The voluntary withholding rate is based on the applicable tax tables, in the case of periodic distributions, and on a 10 percent rate in the case of nonperiodic distributions.

Form 1099-R Reporting Requirements for Loan Offsets

If the loan offset is triggering taxation of the loan, the distribution is reported on Form 1099-R in the same manner as other distributions from the plan. Note that Code L is not used for a loan offset distribution, only for a deemed distribution under IRC §72(p). However, if the loan offset is attributable to a loan that was previously taxed as a deemed distribution under IRC §72(p) (e.g., a defaulted loan), then the amount is not reported as part of the gross distribution on Form 1099-R.

The examples in Q&A-22 of Treas. Reg. §1.72(p)-1 illustrate how the IRS intends loan offsets to be reported on Form 1099-R.

EXAMPLE 10-45. No Prior Taxation on Loan. Amy requests a lump sum distribution from her employer's 401(k) plan. At the time of the distribution, Amy has a current loan balance of $6,000. There has been no previous taxation of the loan under the deemed distribution rules. Amy does not have any basis under the plan for tax purposes.

Amy's total vested account balance is $77,000, which consists of $6,000 loan receivable and $71,000 non-loan assets. Amy does not elect a direct rollover of any portion of her distribution. To make the distribution, the plan offsets the loan receivable and distributes the rest in cash.

The gross distribution is $77,000, which includes the loan offset that is being taxed at this time. The withholding liability is $15,400 (i.e., 20 percent of $77,000). Amy's check from the plan (assuming no state income tax withholding) is $55,600 (i.e., $71,000 non-loan assets minus $15,400 federal income tax withholding).

How is this distribution reported on Form 1099-R? The gross distribution is $77,000, the taxable distribution is $77,000, the withholding amount is $15,400, and the basis (after-tax employee contributions) is $0.

Amy could roll over up to $77,000, because the entire distribution is taxable. The loan portion of that taxable distribution could be rolled over by substituting equivalent cash, or by rolling over the note to a recipient qualified plan. If only a portion of the distribution is directly rolled over, a separate Form 1099-R must be issued on the direct rollover portion.

(1) Distributable cash	$71,000
(2) Loan receivable	$6,000
(3) Gross distribution	$77,000
(4) Amount taxable	$77,000
(5) Amount eligible for rollover	$77,000
(6) Withholding (20% × (3))	$15,400
(7) Net cash distributed [(1) – (6)]	$55,600

EXAMPLE 10-46. Previously Taxed Loan. Bill defaulted on a participant loan in 2017. At the time of the default, the plan deemed a distribution of $12,150. That was reported on Form 1099-R for 2017 (i.e., the calendar year in which the default occurred). The loan receivable remained an asset of the plan because there was no distribution event with respect to the defaulted amount. The plan posted accrued interest, but did not report the accrual of interest as a deemed distribution (which is the correct treatment of the interest).

In 2020, Bill terminates employment and requests a lump sum distribution of his account. At the time of the distribution, Bill's account consists of $61,300 cash and $15,250 loan receivable (which includes the $12,150 initial default amount and $3,100 accrued interest). The plan offsets the loan receivable and the accrued interest and distributes the cash (20 percent of which is withheld for federal income taxes).

The Form 1099-R issued for 2020 should report a gross distribution of $61,300, which is the cash portion of Bill's account, and shows the same amount as the taxable distribution because Bill does not have any tax basis. He does not get tax basis for the previously taxed loan because the loan offset is not reported as part of the gross distribution. Because the loan receivable and the accrued interest are not treated as part of the distribution, the 20 percent withholding liability is calculated only on the cash portion of $61,300.

(1) Total account	$76,550
(2) Distributable cash	$61,300
(3) Loan receivable	$15,250
($12,150 deemed in 2017 + $3,100 accrued interest)	
(4) Gross reportable distribution	$61,300
(5) Amount taxable	$61,300
(6) Amount eligible for rollover	$61,300
(7) Withholding (20% x amount in (2))	$12,260
(8) Net cash distributed	$49,040

EXAMPLE 10-47. Form 5500 Reporting. Because Bill's loan in EXAMPLE 10-46 is an earmarked loan from a defined contribution plan, for the 2017 plan year, the plan reports the deemed distribution of $12,150, and the loan is reported only in the beginning-of-the-year assets on Schedule H or Part III of Form 5500-SF.

For the 2018 plan year, the loan is not being reported as an asset of the plan on Schedule H or Part III of Form 5500-SF, but is an asset for other purposes (e.g., value of Bill's account for top-heavy testing purposes). For the 2020 plan year, the loan offset is an actual distribution from Bill's account, but is not reflected on the Form 5500 because it was already reported as distributed in 2017 when the deemed distribution occurred. However, after 2020, the loan is not treated as a plan asset for any other purpose.

EXAMPLE 10-48. Payments Made by Participant on Previously Taxed Loan. Suppose, in **EXAMPLE 10-46**, that Bill recommenced loan payments in 2018. By the time the plan makes the lump sum distribution to Bill, the loan

receivable balance is only $10,400. The total loan payments made by Bill after the deemed distribution totaled $5,920, which included additional interest.

Now Bill's account consists of $10,400 loan receivable and $69,115 cash. The cash consists of the $61,300 assumed in EXAMPLE 10-46, plus the loan repayments of $5,920, plus an additional $1,895 of investment earnings that were generated because of the loan repayments made by Bill. The plan reports a gross distribution of $69,115, but the taxable portion of that distribution is only $63,195. Bill has tax basis of $5,920, which represents his total loan repayments following the deemed distribution of the loan. Unlike the deemed distribution, payments made on the previously taxed loan do generate basis to Bill.

If You're Curious …

Interest Deduction Disallowed On Certain Loans

IRC §72(p)(3) disallows a deduction for any interest paid on a participant loan if the loan is made to a key employee, or the loan is secured by elective contributions. A key employee is determined under the top-heavy rules in IRC §416(i). The disallowance of an interest deduction for a loan secured by elective contributions applies to any employee, whether or not a key employee. This disallowance rule has limited impact, because interest on most loans would be nondeductible under current law. However, if the loan from the plan is secured solely by a principal residence, the interest may be deductible, pursuant to IRC §163. In that situation, the interest deduction would be disallowed under the two circumstances mentioned above: the loan is to a key employee or it is secured by elective contributions.

To protect the interest deduction, a non-key participant would need to secure the loan solely with the principal residence. In other words, in the event of a default, the plan is not able to reduce the accrued benefit of the participant through a loan offset, but would be limited to looking solely to the principal residence as security. This type of security could place the plan administrator (who is usually the employer) in an uncomfortable situation in having to protect the participant's accrued benefit through foreclosure proceedings on a loan. As a result, it is rare for a plan to permit this type of security, and the loan interest is, therefore, not deductible to the participant.

10.04: ERISA Rules Regarding Participant Loans

EXEMPTION FROM PROHIBITED TRANSACTION RULES

Under the prohibited transaction rules of the IRC and ERISA, the plan may not lend money to a party-in-interest. A plan participant is generally a party-in-interest. However, there is a statutory

exemption from the prohibited transaction rules for participant loans.[81] If the requirements of this exemption are met, the loan is not considered to be a prohibited transaction.

The prohibited transaction rules are important for another reason. IRC §401(a)(13) prohibits the alienation of the participant's benefit. This means that the participant's account or benefit cannot be used to secure a loan. However, it is very common for a participant's account to secure a participant loan. This is permitted because of an exemption to the anti-alienation rules for participant loans that are not prohibited transactions.[82] Therefore, if the loan fails to qualify for the exemption and becomes a prohibited transaction, the plan may be disqualified for violating IRC §401(a)(13). As a result, ensuring that a plan does not engage in a noncompliant loan is very important.

The exemption requirements for participant loans are described in more detail in DOL Reg. §2550.408b-1. The DOL regulations govern both the IRC and the ERISA exemptions from the prohibited transaction rules. Note that this exemption applies to a loan to an employee only if the employee is a participant in the plan.

Exemption Requirements

Available on Reasonably Equivalent Basis

The loan must be available to all participants and beneficiaries on a reasonably equivalent basis.[83]

Loans do not fail to be available on a reasonably equivalent basis merely because a minimum loan amount up to $1,000 is required by the plan.[84] The minimum loan requirement may be disregarded in determining whether the loans are available on a nondiscriminatory basis.[85]

If You're Curious …

The reasonably equivalent rule generally requires that loans also be available to former employees and beneficiaries, as well as to active employees. However, in Advisory Opinion 89-30A, the DOL stated its position that the availability of the loans may be restricted to parties-in-interest. That would include all active employees, and only former employees or beneficiaries who satisfy the party-in-interest definition in ERISA §3(14). Generally, former employees or beneficiaries are not parties-in-interest, unless they are owners, directors or officers of the employer, or have similar relationships with a business substantially owned by the employer. Merely being a participant (i.e., still having an unpaid vested accrued benefit in the plan) does not make a former employee a party-in-interest.

An alternate payee (e.g., former spouse) under a QDRO is a beneficiary for this purpose. If the plan limits loans to parties-in-interest, an alternate payee would not be eligible for a loan unless the alternate payee is a party-in-interest. In some cases, there might be a

[81] IRC §4975(d)(1), ERISA §408(b)(1).
[82] IRC §401(a)(13)(A).
[83] DOL Reg. §2550.408b-1(b).
[84] DOL Reg. §2550.408b-1(b)(2).
[85] Treas. Reg. §1.401(a)(4)-4(b)(2)(ii)(E).

significant delay between the issuance of a QDRO and the actual payment to the alternate payee. For example, if the participant has not reached his or her earliest retirement age under IRC §414(p)(4)(B), the QDRO cannot require payment to the alternate payee unless the plan permits QDRO distributions before the participant's earliest retirement age. If the loan program is not available to the alternate payee, the alternate payee would not have any means of accessing the funds prior to the time of distribution.

The Sarbanes-Oxley Act (SOX) added §13(k) to the Securities Exchange Act of 1934, which makes it unlawful for any publicly traded company to lend or arrange for a loan to certain directors and executives. The law is unclear as to whether this language prohibits participant loans from a plan to the affected employees. The rationale is that the employer sets forth the plan terms and usually promulgates the loan procedures, so could be deemed to “arrange for” a participant loan.

It is up to the Securities and Exchange Commission to determine the answer to the question of the applicability of SOX to participant loans, and it has not yet done so. As a precaution, some publicly traded companies considered excluding the potentially affected executives from the participant loan program. This limitation on the availability of loans could be considered to violate the requirement that loans be offered to all participants on a reasonably equivalent basis. The DOL has concluded that a decision to disallow loans to affected executives based on the SOX limitation would not be a failure to provide loans to all participants on a reasonably equivalent basis.[86]

Nondiscriminatory in Amount

Loans may not be available to HCEs, officers or shareholders in amounts greater than they are available to other employees.[87] Loans may be limited to a maximum percentage of the vested accrued benefit (e.g., 50 percent) or to a maximum dollar amount (e.g., $50,000).

Note that plans usually will not permit loans in excess of 50 percent of the vested accrued benefit because of the adequate security requirements (see below).

Required Documentation

There must be specific loan provisions in the plan, or in a separate written program incorporated by reference into the plan.[88] These provisions must address the following items.

- Person(s) authorized to administer loan program;
- A procedure for applying for a loan;
- Limitations (if any) on the amount of loan available or the permitted purposes for the loan;
- Collateral that must be given for a loan (Most plans will secure loans exclusively with the participant’s vested benefit.);
- The procedure for determining a reasonable rate of interest; and
- Events that constitute default.

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[86] Field Assistance Bulletin 2003-1 (April 15, 2003).
[87] DOL Reg. §2550.408b-1(c).
[88] DOL Reg. §2550.408b-1(d).

Reasonable Rate of Interest Must be Charged

The plan must charge a commercially reasonable rate of interest.[89] The interest rate must be commensurate with the interest rates charged by persons in the business of lending money for loans that would be made under similar circumstances.

Remember that the Servicemembers Civil Relief Act of 2003 (SCRA) imposes an interest rate limitation on loans made to individuals who, subsequent to the origination of the loan, are called to active military duty. This limitation supersedes the interest rate requirement under ERISA, because ERISA does not preempt this rule.

Many plans administer this provision by reviewing a sampling of third-party lenders (e.g., commercial banks) and the rates charged for similarly secured loans. Some plans use a formula tied to a commercially recognized benchmark (e.g., 1 percent or 2 percent above prime rate in effect at beginning of the month), but the DOL will not give an opinion as to whether any particular benchmark is reasonable under the circumstances. Although plans that use this approach are generally not challenged by IRS auditors or DOL examiners, it is the responsibility of the plan administrator (or other fiduciary who is delegated this responsibility) to determine if the interest being charged by the plan satisfies the commercially reasonable standard.

To date, the DOL regulations do not establish a safe harbor standard for determining commercially reasonable interest.

Adequate Security Requirement

The loan must be adequately secured.[90] No more than 50 percent of the vested accrued benefit may be considered by the plan as security for the outstanding balance of all plan loans made to the participant. The 50 percent limit is not exceeded if it is satisfied immediately after the origination of each loan, even if a loan later exceeds 50 percent of the vested interest.

Spousal Consent

If the plan is subject to the QJSA rules, spousal consent must be obtained on the use of any portion of the participant's accrued benefit as collateral.[91] If the plan is not subject to the QJSA rules, the participant may consent to the use of his or her accrued benefit as collateral without obtaining spousal consent.[92]

Although spousal consent is not specifically required for the prohibited transaction exemption, failure to obtain the consent where spousal consent is required would render the loan inadequately secured if the accrued benefit were the only collateral given. If the QJSA rules are not applicable,

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[89] DOL Reg. §2550.408b-1(e).
[90] DOL Reg. §2550.408b-1(f).
[91] IRC §417(a)(4); ERISA §205(c)(4).
[92] Treas. Reg. §1.401(a)-20, Q&A-24.

there is no requirement to obtain spousal consent, so failure to do so would not render the loan inadequately secured.

The spouse's consent is not valid unless it is in writing, is witnessed by a plan representative or notary public and is made no earlier than the beginning of the 90-day period ending on the date the loan is to be secured by the accrued benefit.[93]

No spousal consent is required if the value of the total accrued benefit that is subject to the security interest is not in excess of the cash-out limit in effect under Treas. Reg. §1.411(a)-11(c)(3)(ii) (i.e., $5,000).[94] For a defined contribution plan, the participant's entire account balance is compared to the cash-out limit. For a defined benefit plan, the present value of the participant’s accrued benefit is compared to the cash-out limit. Note that the total benefit is taken into account to determine if the $5,000 threshold is exceeded, not just the vested portion of that benefit. This is different from other consent requirements, where only the vested interest is taken into account.

Some plan documents (or the separate written loan policies under which a plan operates) will require spousal consent for using the accrued benefit as security, even if the plan is not subject to the QJSA rules. In other words, the plan might require spousal consent even though the regulations do not. If spousal consent is required under the terms of the plan (or under the terms of the written loan policy), the plan administrator has an obligation to follow such requirements. A failure to follow the plan’s loan procedures by not obtaining spousal consent when the governing documents require it would create an ERISA enforcement issue (i.e., the spouse has a right under the governing documents of the plan to protect the accrued benefit by refusing consent), and a plan qualification issue (i.e., IRS treats a failure to follow the terms of the plan as an operational failure that may result in disqualification, but which can be corrected through EPCRS), even if the plan could have been written differently with respect to its spousal consent rule.

The plan may obtain spousal consent through an electronic medium, but the consent must still be witnessed by a plan representative or a notary public.[95] This is a difficult requirement to meet electronically, so most spousal consents are still in writing.

Protection from Risk of Loss

The responsible fiduciary must consider whether the other participants are reasonably protected from risk of loss. If the loan is secured solely with the participant's vested accrued benefit, this

[93] Treas. Reg. §1.401(a)-20, Q&A-24.
[94] Treas. Reg. §1.401(a)-20, Q&A-24.
[95] Treas. Reg. §1.401(a)-21.

issue may be more significant because of the potential for delay between a default on the loan and the plan's ability to foreclose against the accrued benefit through a loan offset.

If loans are held as segregated (or earmarked) investments under a defined contribution plan, the risk of loss to other participants is eliminated.

If the loan program requires the participant to consent to payroll withholding for repayment of the loan, the risk of loss to other participants is minimized even though the loan is held as a pooled investment for the plan participants.

If You're Curious …

Loans to Limited Participants with Rollover Accounts Before Satisfying Eligibility Requirements

Some plans allow employees to make rollover contributions to the plan before they have satisfied the plan's eligibility requirements. The IRS calls these employees limited participants, because their participation in the plan is limited to the right to make rollovers until they complete the plan's eligibility requirements.[96] The IRS has not provided guidance as to whether loans are permissible to limited participants. However, the prohibited transaction exemption for participant loans should cover loans to limited participants who have made rollover contributions to the plan. This conclusion is based on the DOL's definition of a participant. DOL Reg. §2510.3-3(d)(ii)(A) provides that an employee becomes a participant on the date on which he or she makes a contribution, whether voluntary or mandatory, to the plan.

State Laws Should be Checked

State laws should be checked to see if there are other consequences of making loans from the plan. There have been no published cases that take the position that state lending laws are preempted by ERISA merely because they might be applied to an ERISA plan's participant loan transactions.

Failure to comply with applicable state law requirements could render the loan inadequately secured, raising prohibited transaction issues. In addition, failure to perfect the plan's security interest could result in an IRS lien having priority over the plan's interest. This could create fiduciary issues where participant loans are held by the plan as a general trust investment rather than as an earmarked investment for the borrowing participant.

[96] Rev. Rul. 96-48, 1996-2 C.B. 31.

Ramifications of Failure to Follow Prohibited Transaction Exemption

If the exemption requirements under DOL Reg. §2550.408b-1, as described above, are not satisfied with respect to a participant loan, the loan is treated as a prohibited transaction and is subject to the excise taxes under IRC §4975.

Antiassignment Issue

If a participant loan is made that does not satisfy the exemption requirements, and that loan is secured by the participant's accrued benefit, the plan is in violation of the antiassignment rule, resulting in plan disqualification.[97]

10.05: Truth-in-Lending Rules

If You're Curious …

The Truth-in-Lending rules (Regulation Z under Title 12 of the Code of Federal Regulations) require lenders to provide information about a proposed loan to the borrower. These rules apply to a plan that has made more than 25 loans in the preceding year, but only in relation to loans taken prior to July 1, 2012. Plans do not have to provide the Truth-in-Lending disclosure after that date.

The 25-loan threshold is decreased to five in the case of loans secured by a dwelling. ERISA does not preempt the Truth-in-Lending rules.

The required disclosures include such items as:

- the plan name;
- the amount of the loan;
- any itemization of the amount of the loan (e.g., if fees, etc. are incorporated into the loan amount);
- any finance charges;
- the annual percentage interest rate;
- any variable interest rate;
- the total amount to be paid under all scheduled payments;
- disclosure of any demand feature;
- disclosure of any prepayment penalties that might apply;
- any penalties that would apply on late payment;
- what is securing the loan (e.g., the vested interest); and
- the number, amounts, and timing of loan payments due.[98]

If a plan failed to comply with the Truth-in-Lending rules, the plan administrator may be subject to certain penalties. Willful or knowing violations of these rules may result in a fine of up to $5,000 or imprisonment of up to one year. Furthermore, plan participants

[97] Treas. Reg. §1.401(a)-13(d)(2).
[98] 15 U.S.C. 1638, 12 CFR 226.18.

may sue to recover the amount of any damages caused by their failure to receive these disclosures, plus attorneys' fees, plus an amount equal to twice the interest or finance charge connected with the loan. There is an exception to the civil penalties if the plan administrator made a good faith effort to comply with the rules, but a violation occurred because of a bona fide error, such as a clerical mistake, a computer glitch or programming error, if the error is corrected promptly after discovery.

10.06: Loan Worksheet

Worksheet to calculate the maximum available loan amount.

Part A

1)	Maximum statutory loan amount	$50,000
2)	Highest outstanding loan balance for 12 months ending on date new loan is made	________
3)	Current outstanding loan balance	________
4)	Subtract 3 from 2	________
5)	Reduced maximum statutory limit (subtract 4 from 1)	________

Part B

6)	Statutory limit ($10,000 if plan so provides; $0 if not)	________
7)	50 percent of participant's vested balance*	________
8)	Greater of 6 or 7	________

New Loan Limit

9)	Lesser of 5 or 8	________
10)	Current outstanding loan balance	________
11)	Maximum new loan amount (subtract 10 from 9)	________
12)	Current vested balance less outstanding loan balance	________
13)	Regulatory amount available for loan (lesser of 11 or 12)	________

* Current vested balance includes outstanding loans

10.07: Review of Key Concepts

- Name the conditions that allow a participant loan to satisfy the exceptions listed in IRC §72(p).
- What is the maximum amount of a participant loan?
- What are the rules applicable to refinancing loans?
- What are the loan repayment requirements and the exceptions for principal residences?
- Explain the rules for suspension of loan repayments for leaves of absence and military service periods.
- Explain when the reduction of the $50,000 loan limit may apply.
- Describe situations under which a loan may be in default.
- What is a deemed distribution?
- Explain the tax consequences and the reporting and withholding requirements of a deemed distribution.
- What is a loan offset?
- Explain the tax consequences and the reporting and withholding requirements of a loan offset.

- Explain the rollover rules that are applicable to participant loans.
- What are the requirements that must be met for a participant loan to be exempt from prohibited transaction rules?

10.08: For Practice – True or False

1. Assuming a participant has taken no previous loans from the plan, the maximum participant loan is the lesser of (1) 50 percent of the participant's vested benefit or account balance, or (2) $50,000.
2. The terms of a loan must require the repayment over no more than a five-year period unless it is for the purchase of the participant's primary residence.
3. Spousal consent may be required for participant loans.
4. If a loan is due to financial hardship, the interest does not need to be amortized over the life of the loan, but may be made payable at the end of the loan in a balloon payment.
5. Loans may be made available to HCEs and not NHCEs.
6. A deemed distribution is a taxable event reported on Form 1099-R in the year in which the deemed distribution occurs.
7. Loan repayments may be suspended for up to two years for a maternity leave of absence.
8. A participant loan must be evidenced by an enforceable agreement.
9. Loan repayments must be made at least quarterly.
10. A cure period is a period of time during which the participant may make up any missed loan payments to avoid suffering the tax consequences of a deemed distribution.

10.09: Sample Test Questions

1. All of the following are requirements for a participant loan to be exempt from the prohibited transaction rules, EXCEPT:

   A. Loans must be repaid through payroll deductions.
   B. Loans must be adequately secured.
   C. Loans must be made according to specific written procedures.
   D. Loans must bear a reasonable rate of interest.
   E. Loans must be made available on a reasonably equivalent basis.

2. Which of the following statements regarding participant loans is/are TRUE?

   I. The cure period may not extend beyond the last day of the calendar quarter in which the missed installment payment was due.
   II. Loans do not fail to be available on a reasonably equivalent basis merely because a minimum loan amount up to $1,000 is required by the plan.
   III. Collateral in addition to the participant's vested interest will be required if a plan uses the $10,000 minimum rule and a loan exceeds 50 percent of the vested accrued benefit.

   A. I only
   B. II only

C. I and III only
D. II and III only
E. I, II and III

3. All of the following statements regarding refinancing a participant loan are TRUE, EXCEPT:

A. The loan being paid off is called the replaced loan.
B. The new loan due to refinancing is called the replacement loan.
C. The interest rate on the replacement loan is automatically considered commercially reasonable if it is no less than the interest rate on the replaced loan.
D. A replacement loan may have a repayment term of up to five years.
E. The replacement loan may have the $50,000 limit reduced by the highest outstanding loan balance in the last 12 months.

4. All of the following statements regarding deemed distributions are TRUE, EXCEPT:

A. A deemed distribution may occur if the participant fails to make timely loan repayments.
B. A deemed distribution is a taxable event to the participant.
C. A deemed distribution may be subject to the 10 percent tax on early distributions.
D. A deemed distribution may occur if a participant loan is made in excess of applicable loan limits.
E. A deemed distribution is an eligible rollover distribution.

5. Which of the following statements regarding deemed distributions is/are TRUE?

I. The amount deemed to be distributed is includible in gross income.
II. A deemed distribution relieves the participant's obligation to repay the loan.
III. Deemed distributions are not subject to the 20 percent mandatory tax withholding requirements.

B. I only
C. II only
D. I and III only
E. II and III only
F. I, II and III

6. Based on the following information, determine the maximum loan amount available to the participant on December 16, 2019:

- The participant's vested balance is $200,000 on December 16, 2019.
- The plan allows a maximum of 4 loans per participant.

Loan	12/16/2019 Balance	09/28/2020 Balance	12/16/2020 Balance
1	$20,000	$17,500	$16,000
2		$10,000	$9,300
Total	$20,000	$27,500	$25,300

A. $20,000
B. $22,500
C. $24,700
D. $30,000
E. $50,000

7. Based on the following information, determine the amount of federal income tax withheld:

    - The participant terminates in September.
    - The participant takes a total distribution in October of the same year.
    - The participant's vested account balance is $65,000 including an outstanding loan of $50,000.
    - The participant wants to roll $10,000 directly to an IRA and take the remaining proceeds as cash.

    A. $3,000
    B. $5,000
    C. $11,000
    D. $13,000
    E. $15,000

8. Based on the following information, determine the maximum amount available for a new loan to the participant on January 1, 2020:

    - The participant is not a participant in any other plan.
    - All required loan payments have been made timely.
    - No other loans have been taken during 2019.
    - The plan allows for multiple loans per participant.
    - The participant has only one loan currently outstanding.

Vested account balance as of January 1, 2020 including the outstanding loan balance	$110,000
Outstanding loan balance on January 1, 2020	$41,000
Outstanding loan balance on January 1, 2019	$50,000

    A. $0
    B. $9,000
    C. $25,000
    D. $50,000
    E. $55,000

9. All of the following statements regarding deemed distributions are TRUE, EXCEPT:

    A. The deemed distribution is the entire loan amount if the loan's basic structure violates the IRC §72(p) rules.
    B. The deemed distribution is the amount of the outstanding loan if the deemed distribution is due to a failure to satisfy the loan repayment rules.

C. The deemed distribution is the amount in excess of the loan dollar limit if the amount of the loan exceeds loan limits under IRC §72(p).
D. A deemed distribution is subject to the same tax rules under IRC §72 as an actual distribution from a plan.
E. Tax withholding is always required when a deemed distribution occurs.

10. Which of the following statements regarding loan refinancing is/are TRUE?

    I. Only one loan may be replaced during a refinancing transaction.
    II. Refinancing transactions are often used when the plan does not permit more than one loan outstanding at the same time.
    III. The 50% limit applicable to the participant's vested account balance must be redetermined as of the date of the refinancing.

A. I only
B. II only
C. I and III only
D. II and III only
E. I, II and III

See next page for answers to the true/false and sample test questions.

10.10: Solutions to True or False Questions

1. False. The initial maximum participant loan is generally 50 percent of the participant's vested benefit. However, a loan could exceed the maximum 50 percent rule if the loan is made under the $10,000 de minimis option.
2. True.
3. True.
4. False. Loans must be fully amortized over the life of the loan. Balloon payments are not acceptable types of loan arrangements in qualified plans, regardless of the purpose of the loan.
5. False. Loans may not be made available to HCEs in an amount greater than the amount made available to NHCEs.
6. True.
7. False. Loan repayments can only be suspended for up to one year for a leave of absence that is not due to military leave.
8. True.
9. True.
10. True.

10.11: Solutions to Sample Test Questions

1. The answer is **A**. Loan payments must be substantially equal and made at least quarterly but are not required to be made through payroll deductions.

2. The answer is **D**. The cure period may not extend beyond the last day of the calendar quarter following the calendar quarter in which the missed installment payment was due.

3. The answer is **C**. The interest rate charged on the replacement loan must be considered a reasonable rate of interest. It is not in any way determined by the interest rate on the replaced loan.

4. The answer is **E**. A deemed distribution is not eligible for rollover. It is a taxable event to a participant who is not otherwise eligible for an actual distribution.

5. The answer is **C**. A deemed distribution does not affect the participant's continued obligation to repay the loan. The loan obligation is not extinguished until the loan is repaid through a resumption of loan payments or by loan offset.

6. The answer is **B**. The maximum loan amount is the lesser of (a) 50 percent of the participant's account balance or (b) $50,000 reduced by the maximum outstanding balance of loans in the 12 months ending on the day before the loan was taken. The participant's vested interest in this case is greater than $100,000, so section (b) applies. The $50,000 maximum is reduced by the difference between the highest outstanding loan balance ($27,500) and the current outstanding loan balance ($25,300), or $2,200: $50,000 - $2,200 = $47,800 maximum loan balance as of December 16, 2019. This amount is then reduced by the currently outstanding loans ($25,300) to get the amount available for a new loan ($22,500).

7. The answer is **B**. The withholding is calculated on the portion of the gross distribution that is not rolled over ($55,000 X .20) = $11,000. However, only $5,000 in cash is available after the rollover ($65,000 vested balance - $50,000 loan asset - $10,000 rollover) so the amount withheld is $5,000.
8. The answer is **A**. The maximum loan amount is the lesser of (a) 50 percent of the participant's account balance or (b) $50,000 reduced by the maximum outstanding balance of loans in the 12 months ending on the day before the loan was taken. The participant's vested interest in this case is greater than $100,000, so section (b) applies. The $50,000 maximum is reduced by the difference between the highest outstanding loan balance ($50,000) and the current outstanding loan balance ($41,000), or $9,000: $50,000 - $9,000 = $41,000 maximum loan balance as of January 1, 2019. This amount is then reduced by the currently outstanding loans ($41,000) to get the amount available for a new loan ($0).
9. The answer is **E**. When a deemed distribution occurs on a date which is after the loan is made, no withholding is required unless other cash or property is being distributed at the same time.
10. The answer is **D**. More than one loan may be replaced by a new loan during a refinancing transaction.

CHAPTER 11:

CODE OF PROFESSIONAL CONDUCT

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11.01: Code of Professional Conduct

The purpose of this Code of Professional Conduct (“Code”) is to identify the professional and ethical standards with which a Member must comply, in order to fulfill the Member’s responsibility to the American Retirement Association and its affiliate organizations, other Members, and the public. Members are required to adhere to the high standards of conduct, practice, and qualification set forth in this Code.

DEFINITIONS

- Actuary: an individual who is a Member of the American Retirement Association and holds an MSPA or FSPA from the ASPPA College of Pension Actuaries or an actuarial credential from another organization that is a member of the International Actuarial Association (IAA) or is an enrolled actuary in good standing with the Joint Board for the Enrollment of Actuaries.
- Advertising: all communications by whatever medium, including oral communications, which may directly or indirectly influence any person or organization to decide whether there is a need for Professional Services or to select a specific person or firm to perform such services.
- Confidential Information: information not in the public domain of which the Member becomes aware during the course of rendering Professional Services to a Principal. It may include information of a proprietary nature, information which is legally restricted from circulation, or information which the Member has reason to believe that the Principal would not wish to be divulged.
- Credential: a membership designation (e.g., Certified Pension Consultant; Member, Society of Pension Actuaries; or Associated Professional Member) conferred by American Retirement Association.
- Law: statutes, regulations, judicial decisions, and other statements having legally binding authority.
- Member: An individual who is a Member of American Retirement Association or any affiliate organization of American Retirement Association.
- Principal: any present or prospective client of a Member or the employer of a Member where the Member provides retirement plan services for their employer’s plan.
- Professional Communication: a written, electronic or oral communication issued by a Member with respect to Professional Services.
- Professional Services: services provided to a Principal by a Member, including the rendering of advice, recommendations, findings, or opinions related to a retirement or other employee benefit plan.
- Titles: leadership positions, volunteer experience, awards and other honors conferred by American Retirement Association.

ADVERTISING

A Member shall not engage in any Advertising with respect to Professional Services that the Member knows or is reasonably expected to know are false.

COMMUNICATIONS

A Member who issues a Professional Communication shall take appropriate steps to ensure that the Professional Communication is appropriate to the circumstances and its intended audience.

COMPLIANCE

A Member shall be knowledgeable about this Code, keep current with Code revisions and abide by its provisions. Laws may impose binding obligations on a Member. This Code is not intended to supplant, contradict or supersede Law (e.g., Circular 230) or other Codes of Conduct that establish professional standards for Members in the rendition of Professional Services and that have been sanctioned by the federal or a state government. Where the requirements of

Law or such governmentally-sanctioned Codes conflict with this Code, the requirements of Law or such governmentally-sanctioned Codes take precedence.

CONFIDENTIALITY

A Member shall not disclose to another party any Confidential Information obtained in rendering Professional Services for a Principal unless authorized to do so by the Principal or required to do so by Law.

CONFLICTS OF INTEREST

A Member shall not perform Professional Services involving an actual conflict of interest unless:

- The Member's ability to act fairly is unimpaired; and
- There has been full disclosure of the conflict to the Principal(s); and
- All Principals have expressly agreed to the performance of the services by the Member.

If the Member is aware of any significant conflict between the interests of a Principal and the interests of another party, the Member should advise the Principal of the conflict and include appropriate qualifications or disclosures in any related communication.

CONTROL OF WORK PRODUCT

A Member shall not perform Professional Services when the Member has reason to believe that they may be altered in a material way or may be used to violate or evade the Law. The Member should recognize the risk that materials prepared by the Member could be misquoted, misinterpreted or otherwise misused by another party to influence the actions of a third party and

should take reasonable steps to ensure that the material is presented fairly and that the sources of the material are identified.

COURTESY AND COOPERATION

A Member shall perform Professional Services with courtesy and shall cooperate with others in the Principal's interest. A Principal has an indisputable right to choose a professional advisor. A Member may provide service to any Principal who requests it even though such Principal is being or has been served by another professional in the same manner.

When a Principal has given consent for a new or additional professional to consult with a Member with respect to a matter for which the Member is providing or has provided Professional Services, the Member shall cooperate in assembling and transmitting pertinent data and documents, subject to receiving reasonable compensation for the work required to do so. In accordance with Circular 230, the Member shall promptly, at the request of the Principal, return any and all records of the Principal that are necessary for the Principal to comply with federal tax Law, even if the Member is not subject to Circular 230. The existence of a fee dispute generally does not relieve the Member of this responsibility except to the extent permitted by applicable state Law. The Member need not provide any items of a proprietary nature or work product for which the Member has not been compensated.

DISCLOSURE

A Member shall make full and timely disclosure to a present or prospective Principal of all sources of direct or indirect material compensation or other material consideration that the Member or the Member's firm has received or may receive in relation to an assignment for such Principal. The disclosure of sources of material compensation or consideration that the Member's firm has received, or may receive, is limited to those sources known to, or reasonably ascertainable by, the Member.

PROFESSIONAL INTEGRITY

A Member shall perform Professional Services, and shall take reasonable steps to ensure that Professional Services rendered under the Member's supervision are performed, with honesty, integrity, skill and care. A Member has an obligation to observe standards of professional conduct in the course of providing advice, recommendations and other services performed for a Principal. A Member who pleads guilty to or is found guilty of any misdemeanor related to financial matters or any felony shall be presumed to have contravened this Code and shall be subject to American Retirement Association's counseling and disciplinary procedures.

QUALIFICATION STANDARDS

A Member shall render opinions or advice, or perform Professional Services, only when qualified to do so based on education, training and experience.

TITLES AND CREDENTIALS

A Member shall make truthful use of the membership Titles and Credentials of ARA to which the Member is entitled, and only where that use conforms to the practices authorized by American

Retirement Association. A Member who is not an Actuary as defined in section 1 of this Code shall not professionally represent to the public to be an actuary or knowingly allow such misrepresentation by others.

ADDITIONAL OBLIGATIONS

A Member whose professional conduct is regulated by another membership organization shall abide by the professional Code of Conduct (or similar rules) of such organization. For example, a Member who is an actuary shall also abide by the Code of Professional Conduct for actuaries.

A Member shall respond promptly in writing to any communication received from a person duly authorized by American Retirement Association to obtain information or assistance regarding a Member's possible violation of this Code. The Member's responsibility to respond shall be subject to Section 5 of this Code, "Confidentiality," and any other confidentiality requirements imposed by Law. In the absence of a full and timely response, American Retirement Association may resolve such possible violations based on available information.

11.02: For Practice – True or False

1. Professional services should always be performed with honesty, integrity, skill and care.
2. An ARA member should observe the highest standards of practice.
3. ARA members should only give professional advice when qualified to do so based on education, training or experience.
4. Working for clients with conflicting interests is not permissible even if full disclosure is made and both clients are willing to continue the relationship.
5. An ARA member may be subject to discipline if found guilty of a felony of any type.
6. Precautions should be taken to ensure that professional communications are appropriate to the circumstances and intended audience.
7. The Code of Conduct applies only to credentialed ARA members.
8. It is not permissible for an ARA member to provide services to a principal who is currently being served by another benefits professional in the same matter.
9. Where the requirements of law or regulation conflict with the ARA Code of Professional Conduct, the requirements of law or regulation take precedence.
10. If there is reason to believe that a principal would not want information to be divulged, it should be treated as confidential information.

11.03: Sample Test Questions

1. Which of the following statements regarding ARA's Code of Professional Conduct is/are TRUE?

    I. An ARA member should not advertise professional services in a manner that is misleading.
    II. An ARA member may be subject to discipline if found guilty of a misdemeanor of any type.
    III. An ARA member may only perform professional services when qualified to do so based on education, training or experience.

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

2. Which of the following actions is/are acceptable in accordance with the ARA Code of Professional Conduct?

    I. Releasing account information to a participant’s spouse without the participant’s consent
    II. Recommending that the client change the vesting provisions in a plan that is administered by another firm
    III. Providing a plan amendment to a client after December 31, knowing that the client intends to back date the document

    A. I only
    B. II only

C. I and III only
D. II and III only
E. I, II and III

3. Which of the following actions is/are violations of the ARA Code of Professional Conduct?

    I. Completing a client's coverage test without researching census data error warnings from the software
    II. Being convicted of felony drug possession charges
    III. Being convicted of misdemeanor petty theft

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

4. All of the following actions are acceptable in accordance with the ARA Code of Professional Conduct, EXCEPT:

    A. Discussing a specific participant's investment elections with an unrelated investment advisor
    B. Respectfully expressing a professional opinion to a client that differs from the opinion expressed by another ARA member
    C. Working for clients with conflicting interests if full disclosure is made and both clients agree to continue the relationship
    D. D Releasing account information to a participant's accountant with the participant's written permission
    E. E. Offering to review the provisions of a client's qualified plan that is administered by another firm

5. Which of the following actions is/are violations of the ARA Code of Professional Conduct?

    I. Reviewing the fee structure of another third party administrative firm with the client
    II. Refusing to provide plan conversion data to a client's new service provider
    III. Using the QKA designation on a resume after successfully completing the examinations, but prior to obtaining the experience requirement

    A. I only
    B. II only
    C. I and III only
    D. II and III only
    E. I, II and III

See next page for answers to the true/false and sample test questions.

11.04: Solutions to True or False Questions

1. True.
2. True.
3. True.
4. False. Performing professional services involving a conflict of interest may be permissible if the ARA member's ability to act fairly is unimpaired, the conflict has been fully disclosed to the principals and all principals have expressly agreed to the performance of the services by the ARA member.
5. True.
6. True.
7. False. All ARA members (both credentialed and noncredentialed) are subject to the ARA Code of Professional Conduct.
8. False. A member may provide service to any principal who requests it even if the principal is being or has been served by another benefits professional in the same matter.
9. True.
10. True.

11.05: Solutions to Sample Test Questions

1. The answer is **C**. Not all misdemeanors are addressed by the ARA Code of Professional Conduct. Only conviction of financially-related misdemeanors will subject a member to counseling and disciplinary procedures.
2. The answer is **B**. Releasing account information to a participant's spouse without the participant's consent is a violation of confidentiality. Consent should be obtained before releasing confidential information. Providing a plan amendment to a client after December 31, knowing that the client intends to back date the document is violates the "control of work product" section of the ARA Code of Professional Conduct.
3. The answer is **E**. All three situations violate the "professional integrity" standards of ARA's Code of Professional Conduct. Professional services are not being conducted with skill and care if a client's coverage test is completed without researching census data error warnings from the software. Being convicted of a financially-related misdemeanor or any felony is a violation of the ARA Code of Professional Conduct.
4. The answer is **A**. Discussing a specific participant's investment elections with an unrelated investment advisor is a violation of confidentiality.
5. The answer is **D**. Refusing to provide plan conversion data to a client's new service provider violates the "courtesy and cooperation" section of ARA's Code of Professional Conduct. Using an ARA credential prior to obtaining the experience requirement violates both the "professional integrity" and the "titles and credentials" section of ARA's Code of Professional Conduct.