

NONDISCRIMINATION TESTING

PART 2 - ACTUAL DEFERRAL PERCENTAGE TESTING

After determining the controlled group members, which employees are considered to be highly compensated employees and which plan or plan features pass coverage tests, the actual deferral percentage test under Internal Revenue Code Section 401(k)(3) can be conducted. The following Part 2 discusses the procedures for conducting this test on a step-by-step basis with examples. All factors used to conducting the test will be discussed.

Next month in Part 3, the procedures for conducting the actual contribution percentage test under Internal Revenue Code Section 401(m)(3), the old multiple use of the alternative limitation test under Internal Revenue Code Section 401(m)(9) and for adopting the designed safe harbors under Internal Revenue Code Sections 401(k)(12) and (401(m)(11) will be discussed.

TESTING PROCEDURES

In conducting the actual deferral percentage (ADP) test under Internal Revenue Code Section 401(k)(3), an employer should complete the following steps:

- *Conduct* the minimum coverage tests under Internal Revenue Code Section 410(b) and include employees of the plan or plans that will be included in the testing;
- *Segregate* employees into highly compensated and non-highly compensated employees in the plan or plans being tested;
- *Determine* the actual deferral percentage for each employee being tested by dividing each highly compensated employee's and non-highly compensated employee's employer salary deferrals by the amount of each employee's compensation. The ADP is 0 for each eligible employee who does not contribute;
- *Determine* the average deferral percentage for the highly compensated employee's group and the non-highly compensated employee group by adding together each employee's compensation in the group's actual deferral percentage and dividing it by the number of employees in the group;
- *Conduct* the actual deferral percentage test under Internal Revenue Code Section 401(k)(3) by determining whether the actual deferral percentage for the highly compensated employee group is within one of the limits of the actual deferral percentage for the non-highly compensated employee group;
- *Review* correction procedures if neither limitation under the actual deferral percentage are met. These include withdrawing excess contributions or excess deferrals and income from accounts of highly compensated employees, contributing additional employer matching or non-elective contributions to non-highly compensated employees selected by the employer, and aggregating the plan with other plans sponsored by the employer on a controlled group basis;
- *Determine* whether the multiple use of the alternative limit has occurred (for plan years before 2002);
- *Review* further correction procedures until the aggregate limitation is met. These include shifting matching contributions and qualified non-elective contributions and employer matching contributions to ADP test; withdrawing excess aggregate or excess contributions; and aggregating the plan with other plans sponsored by employer on a controlled group basis.

Coverage Tests under Internal Revenue Code Section 410(b): Before conducting the actual deferral percentage test, the employer must determine whether the plan or plans being tested satisfies one of the two coverage tests under Internal Revenue Code Section 410(b) as discussed earlier in Part 1.

All the minimum coverage tests under Internal Revenue Code Section 410(b) compare the employees benefiting from a plan to those who are not benefiting. With respect to salary deferral contributions, an employee is considered to be benefiting if he or she is eligible to make salary deferral contributions.¹ An employee is not considered to be eligible to make salary deferral contributions if he or she must fulfill additional requirements to make the contribution, such as completing a year of service or being employed on the last day of the year.²

The minimum coverage rules under Internal Revenue Code Section 410(b) can be applied on a per plan basis or by aggregating various plans of an employer. In conducting the ratio percentage test and the nondiscriminatory classification test, the portion of any plan containing employee salary deferral contributions must be tested separately from any other portion of the plan. In applying the average benefit percentage test, the employer may have to aggregate other plans and treat them as one plan as explained in Part 1.³

DETERMINING THE ADP FOR EACH PARTICIPANT AND FOR THE GROUP

Introduction: In determining an employee's actual deferral percentage for a plan year, the first step is to determine what salary deferral contributions can be taken into account. In order for a salary deferral contribution to be considered, the following factors must be met:

- The salary deferral contributions are allocated to the employees account under the plan within the plan year;⁴
- The salary deferral contribution is for compensation that either (1) would have been received by the employee in the plan year, but for the employee's election to defer, (2) is attributable in the plan year, but for the employee's election to defer would have been received by the employee within 2½ months after the close of the plan year⁵, or (3) the salary deferral contribution was not used to satisfy the actual contribution percentage test under Internal Revenue Code Section 401(m).⁶

Compensation Further Defined: The compensation used for determining an employee's actual deferral percentage must meet one of the definitions of compensation under Internal Revenue Code Section 414(s), which has seven possible definitions of compensation.⁷

Employers may wish to refer to the charts at the end of Chapter 1, which summarizes all of the following definitions of compensation under Internal Revenue Code Section 414(s). These include the following:

- The general definition of Internal Revenue Code Section 415 compensation under Treasury Regulations section 1.415-2(d)(1), (2) and (3);
- The modified definition of compensation under Treasury Regulations Section 1.415-2(d)(10);
- Wage reporting under Form W-2 under Treasury Regulations Section 1.415-2(d)(11)(ii);
- Tax withholding under Treasury Regulations Section 1.415-2(d)(11)(ii);
- The safe harbor alternative definition of compensation under Treasury Regulations Section 1.414(s)-1(c)(3);
- The reasonable definition of compensation under Treasury Regulations Section 1.414(s)-1(d).⁸

The first four definitions of compensation indicated in this list are the same definitions explained

earlier, in Chapter 1, in determining highly compensated employee status *except the following modifications may be made* when determining an employee's actual deferral percentage. ⁹

- The tax-deferred contributions made to cafeteria plans, 401(k) plans; 403(b) plans, 457 plans, SEPs, and governmental plans under Internal Revenue Code Section 414(h)(2) may be excludable in the definition of compensation and still satisfy Internal Revenue Code Section 414(s).¹⁰
- The compensation of highly compensated employees may be modified to provide for exclusions of additional items or amounts, including anyone or more of the types of elective contributions tax-deferred contributions indicated above, on a uniform basis from the compensation of highly compensated employees.¹¹

Under the safe harbor alternative definition of compensation, compensation is defined as any of the first four definitions of compensation with the following items excluded: reimbursements or other expense allowances, fringe benefits (both cash and non-cash), moving expenses, deferred compensation, and welfare benefits ¹²

In addition, the safe harbor alternative definition can be further modified to exclude tax-deferred contributions and reduced to provide certain exclusions for highly compensated employees as explained above.¹³

If a definition does not meet any of the previous definitions, an employer may use any other reasonable definition of compensation to determine an employee's actual deferral percentage for the actual deferral percentage test under Internal Revenue Code Section 401(k)(3). This definition may be used only if the average percentage of the total compensation under the alternative definition for highly compensated employees, as a group, does not exceed by more than a de minimis amount the average percentage of the total compensation includable under the alternative definition for the non-highly compensated employees as a group.¹⁴

If the plan administrator determines that the definition of compensation is reasonable, the following items of pay may be excluded from compensation:

- Overtime pay, premiums for shift differentials, and call-in premiums;
- Bonuses for individual performance;
- Any or all types of pay excluded under anyone of the safe harbor definitions indicated above, including reimbursements or other expense allowances, fringe benefits (both cash and noncash), moving expenses, deferred compensation, and welfare benefits.¹⁵

In addition, a reasonable definition of compensation can also exclude any items of salary deferral contributions or deferred compensation described earlier.¹⁶

For example, the Lincoln Company has a 401(k) plan. The plan's definition of compensation includes only base salary. Lincoln's highly compensated employees receive no bonuses or special compensation. Lincoln's non-highly compensated employees receive shift differentials and special bonuses for performance. Because of the way Lincoln's employees are paid, the definition of compensation in Lincoln's plan will probably not be reasonable because a higher percentage of the total compensation of highly compensated employees will be included in the definition of compensation than that of non-highly compensated employees because shift differentials and bonuses were not counted.

When determining the amount of an employee's compensation, the period used must be either the plan year or a calendar year ending within the plan year. The period must be used uniformly for all eligible employees for a plan year. In addition, an employer can limit the amount of compensation used to determine an employee's actual deferral percentage to that amount earned after the employee becomes a participant.¹⁷ } Using compensation earned during a plan year before an employee becomes a participant

could make it more difficult for the employer to pass the actual deferral percentage test under Internal Revenue Code Section 401(k)(3) because it may decrease a participant's actual deferral percentage that is beneficial for highly compensated employees, but not non-highly compensated employees.

The maximum compensation for a plan year is \$200,000 for 2002 and 2003 (as indexed).¹⁸ This limit does not have to be prorated if the deferral amount for a period during a plan year is determined separately using compensation for that period. In addition, the compensation limit does not have to be prorated because an employee participates in a plan for fewer than 12 months in allocations or benefit accruals are otherwise determined using compensation for a period of 12 months.¹⁹

An employer cannot ignore the cumulative compensation limit used to determine deferrals during the plan year. In determining the percentage of compensation that a participant can contribute for a plan year the deferral percentage must be based on \$200,000 and not on the actual compensation earned.

}For example, an individual participating in a 401(k) plan earned \$300,000 and wants to defer \$10,000. When completing his salary deferral election form, what must the participant select to defer this amount?

The participant must select a specific dollar amount or a specific percentage of his or her compensation to be deferred. In this situation, the participant must choose either \$10,000 or 5 percent of his or her eligible plan compensation (5 percent of \$200,000 = \$10,000). If the participant elects to defer 3 percent of his or her eligible plan compensation, the annual deferred amount would be \$6,000 (3 percent of \$200,000). Internal Revenue Code Section 401(a)(17) prevents the plan from considering any participant compensation in excess of \$200,000.

Conducting the Actual Deferral Percentage Test: For any plan year, a plan containing salary deferral contributions will be considered nondiscriminatory if the actual deferral percentage for the highly compensated employee group does exceed the greater of either of the following:

- 125 percent of the actual deferral percentage of the non-highly compensated employee group;
- The lesser of 200 percent of the actual deferral percentage of the non-highly compensated employee group or the actual deferral percentage of the non-highly compensated employee group plus two percentage points.²⁰

An employee's actual deferral percentage is calculated to the nearest .01 percent.²¹

If an employer had to aggregate plans to pass Internal Revenue Code Section 410(b), these same plans must be aggregated to conduct the actual deferral percentage test under Internal Revenue Code Section 401(k)(3).²²

If an employer segregated its employees between those who did and did not meet the minimum service and age requirements as discussed above, the employer must satisfy the minimum coverage requirements for each group, but can disregard non-highly compensated employees for the Actual Deferral Percentage testing.²³

Before conducting the Annual Deferral Percentage Test, an employer must determine whether any participant violates the annual addition limits of Internal Revenue Code Section 415(c). For limitation years beginning on or after January 1, 2002, it will no longer be a concern because the maximum allocated amount to a participant cannot exceed the lesser of 100 percent of compensation or \$40,000 for 2002 and 2003.²⁴

A plan may elect to apply the actual deferral percentage test using the non-highly compensated employee participant data for the current plan year or for the immediate prior year. For a plan using the prior year testing method, it may adopt the current year method for any subsequent testing year. No notification to or filing with the IRS is necessary, but the employer must amend the plan document to reflect which testing method the plan uses.²⁵

Once an employer elects to use the current year method, it may prevent the employer from switching back to the prior year method. Any plan that uses the current year testing method may not permissively aggregate for nondiscrimination testing purposes with a plan that uses the prior year testing method.

A plan that elects the current year testing method cannot switch to the prior year method for a subsequent year unless it meets one of the following requirements:

- the plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the five plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan);
- the plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the five plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan);
- a transaction occurs that is described in Internal Revenue Code Section 410(b)(6)(C)(i) and Treasury Regulations Section 1.410(b)-2(f); as a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and the change from the current year testing method to the prior year testing method occurs within the transition period described in Internal Revenue Section 410(b)(6)(C)(ii); or
- the change occurs during the plans' remedial amendment period for the Small Business Job Protection Act of 1996.²⁶

A major concern with switching from current year testing method to the prior year method is the problem of "double counting" of certain contributions. This concern is illustrated when an employer recharacterizes elective contribution or makes additional non-elective contributions to pass the ADP or ACP test. By switching methods, an employer will be able to double count these corrective contributions and use them for passing ADP and ACP in two separate years.

Correction of the Actual Deferral Percentage Test: If, after conducting the actual deferral percentage test, neither of the above limitations are met, the employer must make corrections to the plan by the end of the following plan year or the plan will be deemed discriminatory and disqualified. The accepted correction procedures include the following:

- *Distribution* of excess salary deferral contributions and income;
- *Recharacterization* of excess salary deferral contributions as employee after-tax contributions;
- *Contributing* additional non-elective employer contributions to non-highly compensated employees;
- Any combination of the above methods.²⁷
- *Re-aggregating* the plan with another plan sponsored by the employer in the controlled group;

When the actual deferral percentage test is not met for any plan year, the first step is to determine the amount of excess to withdraw from the plan and then which highly compensated employee's account will be reduced. To determine the amount of the excess contribution to be withdrawn, an employer must take the following steps:

- *List* the highly compensated employees in order of their individual actual deferral percentage,

starting with the highest individual actual deferral percentage;

- *Reduce* the actual deferral percentage of the highly compensated employee with the highest deferral percentage until equal to the next highest highly compensated employee's actual deferral percentage or until the actual deferral percentage test is met;
- *Reduce* the actual deferral percentage of the next highest two highly compensated employee until equal to the next highest highly compensated employee's actual deferral percentage or until the actual deferral percentage test is met;
- *Repeat* this pattern until the actual percentage test is met.²⁸

To determine which highly compensated employee's account will be reduced; an employer must take the following steps:

- *List* the highly compensated employees in order of their individual salary deferral contributions, starting with the highest individual salary deferral contribution amount;
- *Reduce* the salary deferral contribution amount of the highly compensated employee with the highest salary deferral percentage until equal to the next highest highly compensated employee's salary deferral contribution amount or until the entire excess contribution amount is withdrawn;
- *Reduce* the salary deferral contribution amount of the next highest two highly compensated employee until equal to the next highest highly compensated employee's salary deferral contribution amount or until the entire excess contribution amount is withdrawn;
- *Repeat* this pattern until the entire excess contribution amount is withdrawn.²⁹

For example, Joe's Tire Company maintaining a 401(k) plan with four highly compensated eligible employees whose salary deferral contributions for the plan year are as follows:

Eligible Employee	Compensation Before Reduction	Elective Contributions	Deferral Percentage
1	\$150,000	\$9,000	6.0%
2	\$120,000	\$9,000	7.5%
3	\$100,000	\$9,000	9.0%
4	\$80,000	\$8,000	10.0%

The actual deferral percentage for the non-highly compensated employees is 4%, and thus the maximum permitted actual deferral percentage for the highly compensated is 6%. The actual deferral percentage before distribution (or recharacterization) of excess contributions is 8.13% (6% + 7.5% + 9% + 10% = 32.5% / 4 = 8.13%).

The aggregate amount of the excess is \$8,000. The amount of the excess is allocated based upon dollar amounts of contributions, so that Employees 1, 2 and 3 are each reduced by \$1,000 before any reduction is made in Employee 4's deferrals. Then, all four employees are reduced by \$1,250 to a level of \$6,750 in each case.

When distributing excess contributions, the highly compensated employee must also receive the income attributable to the excess contribution. ³⁰ If a highly compensated employee does not receive all the income attributable to his or her excess contribution, it will be treated as though only a pro rata distribution of excess contribution and income was distributed. Therefore, a portion of the excess contribution will be treated as not being distributed, which if not corrected could disqualify the plan.³¹

Excess contributions cannot be returned to a highly compensated employee until after the end of the plan year to which they relate. There is no authority to return them during the plan year in which they relate. The plan administrator does not need the consent of a participant or his or her spouse to distribute excess

contributions or income relating to the excess contributions. A plan administrator can, if the authority is reserved in the plan, cease salary deferrals to highly compensated employees if he or she determines that the actual deferral test may not be passed.³²

The timing of the return of the excess contributions and income will determine in which tax year the excess contribution and income will be included in the highly compensated employee's income and whether the employer or plan is subject to any consequences. Any return of excess contributions and income is not subject to 20 percent income tax withholding.³³

If excess contributions, plus income allocable to such contributions, are distributed no later than 2½ months after the close of the plan year in which there is an excess, the following will occur:

- The plan will not be disqualified;
- The excess contributions, plus income, will be treated as received and earned in the participant's taxable year in which the excess contribution would have been received as cash if not for the elective contribution, such as the year of deferral;
- The distribution will be exempt from the 10 percent additional income tax on early distributions and the 15 percent excise tax on excess distributions;
- No 10 percent excise tax will be imposed on the employer.³⁴

Certain corrective distributions of de minimis amounts (less than \$100) of excess contributions are includable in the participant's gross income in the year the income is distributed rather than in the year of deferral, if such excess amounts are distributed within the 2½-month period.³⁵

If excess contributions, including income allocable to such contributions, are distributed after 2½ months after the close of the plan year in which there is an excess but before the close of the plan year following the plan year in which the excess contributions are distributed the following will occur:

- The plan will not be disqualified;
- The excess contribution, plus income allocable to such contributions, will be included in the participant's income in the taxable year of distribution, rather than the prior year;
- The distribution will be exempt from the 10 percent additional income tax on premature distributions and 15 percent tax on excess distributions;³⁶
- An excise tax equal to 10 percent of the excess contributions will be imposed on the employer. The penalty must be reported on Form 5330 and the employer must attach the form to the company's tax return.³⁷

The tax is due on the last day of the 15th month after the close of the plan year to which the excess contributions relate.³⁸

If excess contributions are not distributed before the close of the plan year following the plan year to which the excess relates, the plan will be disqualified effective for the year in which an excess exists.³⁹

Income is treated as if it had been in the highly compensated employee's account for the entire plan year even if the excess contribution is the last amount contributed for the plan year. Income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year or, if the plan provides, for the plan year and for the "gap" period (the period between the end of the plan year and the date of distribution).⁴⁰

The advantage of excluding the gap period is that this method reduces the amount of income that must be distributed to the highly compensated employee if the plan does not experience a loss because it considers a shorter period of time. If the plan experiences a loss during the gap period, the highly compensated employee would be distributed more income if the gap period is not included in the

calculation.⁴¹

Whether the gap period is included in the calculation of income must be specified in the plan document.⁴²

Income can consist of all earnings, losses, and appreciation including such items as interest, dividends, rent, gains or losses from the sale of property, appreciation or depreciation in the value of stock, bonds, annuities and life insurance contracts, and other property without regard to whether such appreciation or depreciation has been realized.⁴³ A plan may use any reasonable method of computing the income allocable to excess contributions, including the method used to determine income and loss for other plan assets as long as the method satisfies Internal Revenue Code Section 401(a)(4) and is used consistently for all participants and for all corrective distributions.⁴⁴ In addition, a plan may allocate income to excess contributions by multiplying the income for the plan year and the gap period, if the plan provides allocable to elective contributions and amounts treated as elective contributions by a fraction. The numerator of the fraction is the excess contributions for the employee for the plan year. The denominator of the fraction is equal to the sum of (1) the total account balance of the employee attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year; plus (2) the employee's salary deferrals and amounts treated as elective contributions for the gap period if the gap period income is allocated.⁴⁵

Lastly, if excess contributions are withdrawn after the end of the plan year during the gap period and the plan specifies that the gap period income or loss will be distributed, that income can be determined by using the method used by the plan to determine income or loss, or by using the safe harbor method. Under the safe harbor method, the allocable income for the gap period is equal to 10 percent of the income allocable to excess contributions for the plan year multiplied by the number of calendar months that have elapsed since the end of the plan year. A distribution occurring on or before the 15th of the month will be treated as having been made on the last day of the preceding month and a distribution occurring after the 15th day will be treated as having been made on the first day of the subsequent month.⁴⁶

Any excess contributions returned to a highly compensated employee is still considered an employer contribution for the individual contribution and employer deduction limits of Internal Revenue Code Sections 415 and 404.⁴⁵

Another method of correcting a failed actual deferral percentage test is to treat the excess contributions as employee after-tax contributions. However, the plan must specify that a highly compensated employee has the right to recharacterize. To use this method, the highly compensated employee must exercise this right within 2½ months after the end of the plan to which recharacterization relates.⁴⁸ The amount of the excess contribution that is recharacterized is includable in the highly compensated employee's income on the earliest dates any salary deferrals would be received by the highly compensated employee had that employee originally elected to receive the amounts in cash.⁴⁹

Recharacterized excess contributions must be:

- reported by the plan administrator on Form 1099-R for the year which the recharacterization is made;
- treated as salary reduction contributions for purposes of Internal Revenue Code Sections 401(a) (other than 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417;
- not treated as compensation for purposes of Internal Revenue Code Sections 404 and 415; and
- treated as compensation for purposes of Internal Revenue Code Sections 401(a)(4), 401(a)(5), 401(k), 401(e), and 414(s) only to the extent that salary deferrals may be treated as compensation under the plan;
- tested under Internal Revenue Code Section 401(m);⁵⁰

Note: The ability to recharacterize is a limited right to correct an actual deferral test because these new recharacterized excess contributions are still subject to nondiscrimination rules under Internal Revenue Code Section 401(m). If a plan permits employee after-tax contributions or employer matching contributions and passes the actual contribution percentage test, this option is of very limited use. If a plan permits neither contribution, then recharacterization is of no use to an employer.

For any plan year that the actual deferral percentage test is not passed, an employer can correct the test by making additional profit-sharing or employer matching contributions to the plan for any or all nonhighly compensated employees. These employer contributions must be:

- 100 percent vested when contributed;
- subject to the same distribution restrictions as salary deferral contributions, except they cannot be withdrawn as hardship withdrawals; and
- allocated to the trust by the end of the next plan year.⁵¹

Note: To take full advantage of these contributions, an employer can make additional contributions to selected lowest paid eligible non-highly compensated employees.

Internal Revenue Code Section 401(a)(4) Concerns and Salary Deferral Contributions: In addition, the right to make each level of salary deferral contributions is considered to be a protected benefit, right, and feature of the plan and must be available to a nondiscriminatory group of employees.⁵² These nondiscriminatory requirements are met if the right to make a level of salary deferral contributions is available to employees in a way that satisfies both the current availability and effective availability standards.⁵³

The right to make a level of elective deferral contributions will be treated as currently available to a group of employees if the group satisfies the minimum coverage requirements of Internal Revenue Code Section 410(b) without regard to the average benefit percentage test, as previously discussed. An employee is deemed to be benefiting only if the right is currently available to that employee.⁵⁴

A right to make a level of elective deferral contributions is treated as effectively available to a group of employees from all facts and circumstances. For example, if employees with specified years of service and make specified levels of salary deferral contributions, it would not be effectively available if most of the employees who could make these contributions were highly paid employees.⁵⁵

INDIVIDUAL DOLLAR LIMITATIONS OF SALARY DEFERRALS

General Rules: In any taxable year, an individual cannot defer more than the limitations specified in Internal Revenue Code Section 402(g), at \$11,000 for 2002 and \$12,000 for 2003. The limit will be increased \$1,000 each year until the limit reaches \$15,000 for 2006. Thereafter, the limit will be indexed. This limitation applies to all plans in which an individual is participating during the taxable year even if participating in unrelated employer plans. If a plan's first year is less than 12 months, the above limitations will not be prorated because the limit is based on the participant's taxable year.⁵⁶

Excess Deferrals: If, for any taxable year, an individual exceeds the limitations of Internal Revenue Code Section 402(g), these excess deferrals must be includable in the individual's gross income for the year.⁵⁷ A participant is required to notify the plan of any excess deferrals no later than the first April 15 or any earlier date specified in the plan following the close of the individual's taxable year.⁵⁸ If a plan is notified by this date and the excess deferral and income from the excess deferral is distributed by April 15 of the year following the close of the individual's taxable year, that excess deferral is excluded from the individual's income. However, the *income* attributable to the excess deferral is includable as income for the taxable year in which the distribution is made.⁵⁹ Such distributions are not subject to the 10 percent early distribution tax if the individual has reached age 59½,⁶⁰ or the 20 percent mandatory income tax on distributions from qualified plans.⁶¹

Unlike corrections of excess contributions explained previously, a plan may provide that an individual who has excess deferrals for a taxable year may receive a corrective distribution of excess deferrals for the same year if (1) an individual or the employer designates the distribution as an excess deferral, (2) the correcting distribution is made after the date on which the plan received the excess deferral, and (3) the plan designates the distribution as a distribution of excess deferrals.⁶²

If an individual fails to withdraw the excess deferral and earnings attributable to the excess by April 15 following the close of the individual's taxable year, both the excess deferral and income on the excess deferral are includable in the individual's income for the taxable year in which they relate (the year of deferral) and for the taxable year in which the excess is distributed. If excess deferrals are not distributed by April 15 following close of the individual's taxable year, then the excess deferrals may only be distributed after a qualifying event (such as separation from service, attainment of age 59½, plan termination, and so on).⁶³ These excess deferrals and income are subject to the 10 percent early distribution tax if the participant hasn't reached 59½ and the 20 percent mandatory income tax withholding.⁶⁴

The determination of earnings attributable to excess deferrals is the same as for earnings attributable to excess contributions except the measuring period is the participant's taxable year instead of the plan year.⁶⁵

The amount of excess deferrals that may be distributed for an employee's taxable year is reduced by any excess contributions previously distributed or recharacterized with respect to an employee for the plan year beginning with or within the taxable year. In the event of such reduction, the amount of excess contributions includable in the income of the individual and reported as a distribution is reduced by any distributions of excess deferrals.⁶⁶

These excess deferrals, even if distributed, are treated as employer contributions for the nondiscrimination tests (Internal Revenue Code Sections 401(a)(4), 401(k)(3), 404, 409, 411, 412, and 416)⁶³. Distributed excess deferrals are not treated as employer contributions for Internal Revenue Code Section 415 purposes.⁶⁷

CONCLUSION

Over the years, employers have tried various methods to ease the burden of performing the actual deferral percentage test. They have increased matching contributions, instituted automatic enrollment and contributed qualified non-elective contributions. They have helped employers somewhat, but the addition of prior year testing and designed safe harbors under Internal Revenue Code Section 401(k)(12) and 401(m)(11) by the Congress has been a real help to employers. Each of these new devices do have drawbacks. In using prior year testing, the employer may not use increased limitations in contributions, possible changes in non-highly compensated employees deferral patterns or law changes until the following year. For designed safe harbors, an employer may find their use may be very expensive. It has to weigh this increased cost with decreases in some administrative costs. Part 3, will discuss designed safe harbors in detail.

FOOTNOTES

1. Treas. Reg. §1.410(b)--3(a)(2)(i)
2. Treas. Reg. §1.401(m)-1(f)(4)(i)
3. Treas. Reg. §1.410(b)-5(d)(3)
4. Treas. Reg. §1.401(k)-1(b)(4)(i)(A)
5. Treas. Reg. §1.401(k)-1(b)(4)(i)(B)
6. Treas. Reg. §1.401(k)-1(b)(4)(ii)
7. Treas. Reg. §1.401(k)-1(g)(2)(i)
8. Treas. Reg. §1.414(s)-1(c)(1)
9. Treas. Reg. §1.414(s)-1(c)(2)
10. Treas. Reg. §1.414(s)-1(c)(4)
11. Treas. Reg. §1.414(s)-1(c)(5)
12. Treas. Reg. §1.414(s)-1(c)(3)
13. Code §414(s)(2) and Treas. Reg. §1.414(s)-1(c)(4)
14. Treas. Reg. §1.414(s)-1(d)(3)
15. Treas. Reg. §1.414(s)-1(d)(2)(ii)
16. Treas. Reg. §1.414(s)-1(d)(2)(ii)
17. Treas. Reg. §1.401(k)-1(g)(2)(i)
18. Code §401(a)(17), IRS Notice 2002-71
19. Treas. Reg. §1.401(a)(17)-1(b)(3)
20. Treas. Reg. §1.401(k)-1(b)(2)
21. Treas. Reg. §1.401(k)-1(g)(1)(i)
22. Treas. Reg. §1.401(k)-1(b)(3)(ii)
23. Code §401(k)(3)(F)
24. Code §415(c), IRS Notice 2002-71
25. Code §401(k)(3)(A), IRS Notice 98-1
26. IRS Notice 98-1, where the last day of the SBJPA remedial amendment period is modified by Rev. Proc. 2000-27
27. Treas. Reg. §1.401(k)-1(f)(1)
28. Treas. Reg. §1.401(k)-1(f)(2)
29. IRS Notice 97-2
30. Treas. Reg. §1.401(k)-1(f)(4) }
31. Treas. Reg. §1.401(k)-1(f)(1)(iv)
32. Treas. Reg. §1.401(k)-1(f)(4)
33. Treas. Reg. §1.402(c)-2, Q/A-4(b)
34. Treas. Reg. §1.401(k)-1(f)(4)(v)(A) and 54.4979-1(c)
35. Treas. Reg. §1.401(k)-1(f)(4)(v)(B)
36. Treas. Reg. §1.401(k)-1(f)(4)(v)(A)
37. Treas. Reg. §1.401(k)-1(f)(6)(i)
38. Treas. Reg. §54.4979-1(a)(3)
39. Treas. Reg. §1.401(k)-1(f)(6)(ii)
40. Treas. Reg. §1.401(k)-1(f)(4)(ii)(A)
41. Treas. Reg. §1.401(k)-1(f)(4)(ii)
42. Treas. Reg. §1.402(g)-1(e)(5)(i)
43. Treas. Reg. §1.401(k)-1(f)(4)(ii)
44. Treas. Reg. §1.401(k)-1(f)(4)(B)
45. Treas. Reg. §1.401(k)-1(f)(4)(C)
46. Treas. Reg. §1.401(k)-1(f)(4)(D)
47. Treas. Reg. §1.401(k)-1(f)(4)(iv)
48. Treas. Reg. §1.401(k)-1(f)(3)(iii)
49. Treas. Reg. §1.401(k)-1(f)(3)(ii)
50. Treas. Reg. §1.401(k)-1(f)(3)(ii)
51. Treas. Reg. §1.401(k)-1(b)(4)
52. Treas. Reg. §§1.401(k)-1(a)(4)(iv) and 1.401(a)(4)-4(e)(3)(iii)(D)
53. Treas. Reg. §1.401(a)(4)-4(a)
54. Treas. Reg. §1.401(a)(4)-4(b)(1)
55. Treas. Reg. §1.401(a)(4)-4(c)
56. Treas. Reg. §1.402(g)-1(b)(1)
57. Treas. Reg. §1.402(g)-1(a)
58. Treas. Reg. §1.402(g)-1(e)(2)
59. Treas. Reg. §1.402(g)-1(e)(8)
60. Code §402(g)(2)(C)
61. Treas. Reg. §1.402(c)-2, Q&A 4
62. Treas. Reg. §1.402(g)-1(e)(3)
63. Code §402(b)(2)
64. Treas. Reg. §1.402(g)-1(e)(8)(i)
65. Treas. Reg. §1.402(g)-1(e)(5)
66. Treas. Reg. §1.402(g)-1(e)(5)

- 67. Treas. Reg. §1.402(g)-1(e)(1)(ii)
- 68. Treas. Reg. §1.402(g)-1(e)(1)(ii)

NONDISCRIMINATION TESTING

PART 3 - ACP TESTING AND DESIGNED SAFE HARBORS

If an employer's plan includes either employer matching contributions or employee after-tax contributions, the actual contribution percentage test under Internal Revenue Code Section 401(m)(3) must be conducted to test these contributions. For plan years commencing before 2002, the multiple use of the alternative limit under Internal Revenue Code Section 401(m)(9) must also be conducted.

The following Part 3 discusses the procedures for conducting these tests and for adopting the designed safe harbors under Internal Revenue Code Sections 401(k)(12) and 401(m)(11). If an employer adopts these safe harbors, it can avoid conducting the actual deferral percentage test (as described in Part 2) and the actual contribution test for any plan year, but it must contribute specified employer matching or non-elective contributions and provide required notices to participants.

TESTING PROCEDURES

Introduction: If a plan, in addition to providing salary deferral contributions, matches these contributions with employer contributions or gives employees an opportunity to contribute employee after-tax contributions, an employer must also conduct an actual contribution (ACP) test under Internal Revenue Code Section 401(m).

In conducting the actual contribution percentage (ACP) test under Internal Revenue Code Section 401(m)(2), an employer should complete the following steps:

- *Conduct* the minimum coverage tests under Internal Revenue Code Section 410(b) and include employees of the plan or plans that will be included in the testing;
- *Segregate* employees into highly compensated and non-highly compensated employees in the plan or plans being tested;
- *Determine* the actual contribution percentage for each employee being tested by dividing each highly compensated employee's and non-highly compensated employee's employer matching contributions or employee after-tax contributions by the amount of each employee's compensation. The ACP is 0 for each eligible employee who either does not contribute or does not receive contributions;
- *Determine* the average contribution percentage for the highly compensated employee's group and the non-highly compensated employee group by adding together each employee's compensation in the group's actual contribution percentage and dividing it by the number of employees in the group;
- *Conduct* the actual contribution percentage test under Internal Revenue Code Section 401(m)(2) by determining whether the actual contribution percentage for the highly compensated employee group is within one of the limits of the actual contribution percentage for the non-highly compensated employee group;
- *Review* correction procedures if neither limitation under the actual contribution percentage are met. These include withdrawing excess aggregate contributions, such as employer matching contributions or employee after-tax contributions and income from accounts of highly compensated employees, contributing additional employer matching contributions to non-highly compensated employees selected by the employer, and aggregating the plan with other plans

sponsored by the employer on a controlled group basis;

- *Determine* whether the multiple use of the alternative limit has occurred (for plan years before 2002);
- *Review* further correction procedures until the aggregate limitation is met. These include shifting salary deferral contributions and qualified non-elective contributions and employer matching contributions to ACP test; withdrawing excess aggregate or excess contributions; and aggregating the plan with other plans sponsored by employer on a controlled group basis.

Coverage Tests under Internal Revenue Code Section 410(b): Before conducting the actual contribution percentage test, the employer must determine whether the plan or plans being tested satisfies one of the two coverage tests under Internal Revenue Code Section 410(b) as discussed earlier in Part 1.

All the minimum coverage tests under Internal Revenue Code Section 410(b) compare the employees benefiting from a plan to those who are not benefiting. With respect to employer matching contributions and employee after-tax contributions, an employee is considered to be benefiting if he or she is eligible to make employee after-tax contributions or to receive employer matching contributions.¹ An employee is not considered to be eligible to receive employer matching contributions if he or she must fulfill additional requirements to receive the contribution, such as completing a year of service or being employed on the last day of the year.²

The minimum coverage rules under Internal Revenue Code Section 410(b) can be applied on a per plan basis or by aggregating various plans of an employer. In conducting the ratio percentage test and the nondiscriminatory classification test, the portion of any plan containing employee after-tax contributions and employer matching contributions must be tested separately from any other portion of the plan. In addition, plans containing employee after-tax contributions and employer matching contributions can be tested together.³ In applying the average benefit percentage test, the employer may have to aggregate other plans and treat them as one plan as explained in Part 1.⁴

Determining Each Participant's Actual Contribution Percentage: In determining the actual contribution percentage for each eligible participant, whether in the non-highly compensated employee group or the and highly compensated employee group, the employee's after-tax contribution and employer matching contribution taken into account include the following:

- Employee after-tax contributions made by the employee during the plan year;
- Employee salary deferral contributions recharacterized as employee after-tax contributions;
- Employee matching contributions paid to the trust no later than 12 months after the close of the plan year and made on behalf of an employee to match the employee's salary deferral contributions or employee after-tax contributions;⁵
- Certain qualified non-elective contributions and salary deferral contributions may be considered.⁶

The compensation used to determine the employee's actual contribution percentage has the same meaning as it does for purposes of the actual deferral percentage, and, therefore, must meet one of the definitions of compensation under Internal Revenue Code Section 414(s), as previously discussed in Part 2.⁷

Conducting the Actual Contribution Percentage Test: For any plan year, a plan containing employee after-tax contributions and employee matching contributions will be considered nondiscriminatory if the actual contribution percentage for the highly compensated employee group does not exceed the greater of 125 percent of the actual contribution percentage of the non-highly compensated employee group or the lesser of 200 percent of the actual contribution percentage of the non-highly compensated employee group plus two percentage points.⁸ An employee's actual contribution percentage is calculated to the nearest .01 percent.⁹

Like in the Actual Deferral Percentage test, an employer may use either current year non-highly compensated employee data or prior year non-highly compensated employer data to conduct the test. An employer may designate one method for the actual deferral percentage test and another method for the actual contribution percentage test. Using different methods will invite added administrative complexity.¹⁰

If an employer had to aggregate plans to pass Internal Revenue Code Section 410(b), these same plans must be aggregated to conduct the actual contribution test under Internal Revenue Code Section 401(m)(3).¹¹

If an employer segregated its employees between those who did not meet the minimum service and age requirements as discussed above, the employer must satisfy the minimum coverage requirements for each group, but can disregard non-highly compensated for the Actual Contribution Percentages.¹²

Correction of the Actual Contribution Percentage Test: If after conducting the actual contribution percentage test neither of the above limitations are met, the plan must make corrections to affected highly compensated employees by the end of the following plan year or the plan will be deemed discriminatory and disqualified.

The accepted correction procedures include the following:

- Distributing excess aggregate contributions and income;
- Contributing additional employer contributions to non-highly compensated employees;
- Reallocating salary deferral contributions and qualified employer contributions{ add footnote here, citing Treas. Reg. §1.401(m)-1(e)(1)(i) };
- Reaggregating the plan with another plan sponsored by the employer in the controlled group.

When the actual contribution percentage test is not passed for any plan year, the employer's first step is to determine the amount of excess to withdraw from the plan and then determine which highly compensated employee's account will be reduced.

To determine the amount of the excess aggregate excess contributions to be withdrawn, the employer must complete the following steps:

- List the highly compensated employees in order of their individual actual contribution percentage, starting with the highest individual actual contribution percentage;
- Reduce the actual contribution percentage of the highly compensated employee with the highest contribution percentage until it is equal to the next highest highly compensated employee's actual contribution percentage or until the actual contribution percentage test is passed, and so on;
- Reduce the actual contribution percentage of the highest two highly compensated employees until equal to the next highly compensated employee's actual contribution percentage or until the actual contribution test is passed.
- Repeat the above pattern until the actual contribution percentage test is passed.¹³

To determine which highly compensated employee's account will be reduced for aggregate excess contributions, the employer must complete the following steps:

- List the highly compensated employees in order of their individual matching contribution amount, starting with the highest individual matching contribution amount;
- Reduce the matching contribution amount of the highly compensated employee with the highest matching contribution amount until it is equal to the next highest highly compensated employee's matching contribution amount or until the entire aggregate excess amount is distributed and so

on;

- Reduce the matching contribution amount of the highest two highly compensated employees until equal to the next highly compensated employee's matching contribution amount or until the entire excess aggregate amount is distributed;
- Repeat the above pattern until the entire excess aggregate amount is distributed.¹⁴

If a highly compensated employee's account contains employee after-tax contributions, employer matching contributions, and an excess aggregate contribution that exceeds the ACP test results, the plan can provide that aggregate excess contributions returned to the employee be made up first of employee after-tax contributions up to the point they are not matched or employer matching contributions. At the point that employee after-tax contributions are matched, proportional amounts of after-tax contributions and employer matching contributions must be returned. This method is necessary to ensure that after correction each level of matching contributions is effectively available to a group of employees that satisfies Internal Revenue Code Section 410(b).

For example, John is the sole highly compensated employee in a thrift plan under which the employer matches 100 percent of employee contributions up to 2 percent of compensation and 50 percent of employee contributions up to the next 4 percent of compensation. For the 2001 plan year, John has compensation of \$100,000. He makes an after-tax contribution of \$7,000 or 7 percent and receives a 4 percent employer matching contribution of \$4,000. Therefore, John's actual contribution ratio is 11 percent (\$11,000/\$100,000). The actual contribution percentage for non-highly compensated employees is 5 percent and the employer determines that John's actual contribution percentage must be reduced to 7 percent to meet the actual contribution percentage test under Internal Revenue Code Section 401(m)(2).

To satisfy the requirements, if the employer distributes the unmatched employee after-tax employee contributions of \$1,000 and \$2,000 of matched employee contributions with their related matches of \$1,000, this would leave John with 4 percent of employee after-tax contributions and 3 percent of employer matching contributions for an actual contribution percentage of 7 percent. The plan could instead distribute all matching contributions. The plan would fail to meet the requirements if it distributed \$4,000 (4 percent) of John's employee after-tax contributions and none of John's employer matching contributions.

Once it has been determined that the amount of excess aggregate contributions must be returned to highly compensated employees, the next step is to determine when these excess aggregate contributions must be returned and the amount of income attributable to the excess aggregate contributions that must be returned. The rules governing this step are the same rules governing excess deferrals.¹⁵

For any plan year that the employer cannot pass the actual contribution percentage test, it can increase the actual contribution ratios of employees by contributing or taking into account qualified non-elective contributions made to non-highly compensated employees or salary deferrals as matching employer contributions. In order for these contributions to meet the actual contribution percentage test, the following conditions must be met:

1. The amount of non-elective contributions, including qualified non-elective contributions, treated as employer-matching contributions must satisfy Internal Revenue Code Section 401(a)(4).
2. The amount of non-elective contributions, excluding those qualified non-elective contributions treated as employer matching contributions for the ACP test and those qualified non-elective contributions treated as elective deferrals including the ADP test must satisfy Internal Revenue Code Section 401(a)(4) requirements.
3. The elective deferrals, including those used for the ACP test, must satisfy the ADP test.
4. The qualified non-elective contributions are allocated under the plan as of a date within the plan year and the elective deferrals must satisfy the requirements for salary deferrals taken into

account under the ADP test for the plan year.

5. The plan that takes qualified non-elective contributions and elective deferrals into account in determining whether employee and employer matching contributions satisfy the ACP test and the plans to which the qualified non-elective contributions and salary deferrals are made, must be or could be aggregated for coverage purposes other than the average benefit percentage tests.¹⁶

Multiple Use of the Alternative Limit: If, in any plan year beginning before January 1, 2002, a highly compensated employee participates in a plan that contains salary deferral contributions and employer matching contributions and/or employer after-tax contributions, Internal Revenue Code Section 401(m)(9) provides that both the actual deferral percentage test under Internal Revenue Code Section 401(k)(3) and the actual contribution percentage test under Internal Revenue Code Section 401(m)(2) cannot be passed by the multiple use of the alternative 200 percent/2 percentage points prong of each test. Multiple use of the alternative limit will be deemed eliminated if a special alternative limitation is met.¹⁷

To use this special alternative, the employer must first eliminate any excess deferrals, contributions in excess of the 200 percent/2 percentage points prong, or contributions in excess of the 200 percent/2 percentage points prong and apply any qualified non-elective contributions and matching contributions to the actual contribution percentage test or the actual deferral percentage test.¹⁸

Next, for the highly compensated employee group for any plan year, an individual's actual deferral percentage and actual contribution percentage cannot exceed the sum of numbers 1 and 2 below or the aggregate limit:

1. 125 percent of either:
 - a. the actual deferral percentage of the non-highly compensated employee group, or
 - b. the actual contribution percentage of the non-highly compensated employee group; and
2. the lesser of:
 - a. 200 percent of either
 - (i) the actual deferral percentage of the non-highly compensated employee group, or
 - (ii) the actual contribution percentage of the non-highly compensated employee group, or
 - b. the actual deferral percentage or the actual contribution percentage of the non-highly compensated employee group plus 2 percentage points.¹⁹

If a multiple use of the alternative limitation occurs, the employer can correct for the multiple use by:

- reducing the actual deferral percentage, the actual contribution percentage, or a combination of both of highly compensated employees,
- making qualified non-elective contributions *or* qualified matching contributions to correct the ADP test, or making qualified non-elective contributions or salary deferral contributions to correct the ADP test, or to a combination of both, or²⁰
- any combination of the above methods.

The excess contributions or excess aggregate contributions are reduced from those highly compensated employees' accounts by using the leveling method discussed previously. If an employer decides to reduce an employee's salary deferral contributions or employee after-tax contributions without reducing an employee's employer matching, there will be a problem with the plan passing the nondiscrimination requirements of Internal Revenue Code Section 401(a)(4). This problem is discussed in the next section.²¹

Salary deferral contributions and qualified non-elective contributions and matching contributions can be transferred from the actual deferral percentage test to the actual contribution percentage test in cases where average deferral percentages of participants more than meet the actual deferral percentage test but the plan cannot pass the actual contribution percentage test or the 200 percent/2 percentage points test portion of the test.²²

It is now possible to transfer to the actual contribution percentage test more salary deferral contributions and qualified non-elective and matching contributions than are strictly necessary to pass the actual contribution percentage test and thus eliminate or mitigate multiple use of the alternative limit. Where both the actual deferral percentage and actual contribution percentage tests are satisfied with reference to the 200 percent/2 percentage points test but prohibited multiple use occurs, the plan may transfer some of the salary deferral contributions and qualified non-elective and employer matching contributions from the actual deferral percentage test to the actual contribution percentage test to eliminate or lessen the effect of the multiple use test.²³

For example, an employer has a qualified plan that contains a 401(k) feature with an employer matching contribution. For 2001, the ADP and ACP for highly compensated employees and non-highly compensated employees are 6% and 4%, respectively. The multiple use of the alternative limitation is determined as follows:

1. 125% of the ADP or ACP of the non-highly compensated employees
 - a. 125% of ADP (4%) = 5%
 - b. 125% of ACP (4%) = 5%
2. The lesser of:
 - a. 200% of either the ADP or the ACP of the non-highly compensated employees
 - (i) 200% of ADP (4%) = 8%
 - (ii) 200% of ACP (4%) = 8%, or
 - b. ACP or ADP plus 2% of the non-highly compensated employees
 - (i) ADP (4%) + 2% = 6%
 - (ii) ACP (4%) + 2% = 6%
3. Aggregate limit for non-highly compensated employees equals the greater of 1 or 2
 - a. (125% of ADP) + (ACP+2%) = 5%+6% = 11%
 - b. (125% of ACP) + (ADP+2%) = 5%+6% = 11%
4. The aggregate limit for the non-highly compensated employee is 11%.

There is a multiple use of the alternative limitation because the aggregate limit for the highly compensated employees is 12%. This can be corrected by reducing the ADP, ACP, or both of the highly compensated employees, by making additional qualified non-elective contributions or elective deferral contributions, to some or all non-highly compensated employees, or any combination of the above.

Before the employer corrects the multiple use as stated above, it should consider shifting salary deferral contributions as illustrated below.

1. Transfer 2% of the salary contributions of the ADP test to the ACP test
 - ADP =
 - HC = 4%

NHC = 2%

ACP =

HC = 8%

NHC = 6%

Aggregate limitation = (B) + (C)

2. 125% of ADP or ACP for the non-highly compensated employees
 - a. 125% of ADP = 2.5%
 - b. 125% of ACP = 7.5%
3. The lesser of
 - a. 200% of either the ADP or ACP of the non-highly compensated employees
 - (i) 200% of ADP = 4%
 - (ii) 200% of ACP = 12%, or
 - b. ACP or ADP plus 2% of the non-highly compensated employees
 - (i) ADP (2% + 2%) = 4%
 - (ii) ACP (6% + 2%) = 8%
4. Aggregate limit of non-highly compensated employees is the greater of 1 or 2
 - a. (125% of ADP) + (ACP + 2%)
= 25% + 8%
= 10.5%
 - b. (125% of ACP) + (ADP + 2%)
= 7.5% + 4%
= 11.5%

The aggregate limitation for the non-highly compensated employees is 11.5%

There is still a prohibited multiple use of the alternative limitation because the aggregate limit for the highly compensated employees is 12%. By using this method, the employer has a lesser amount to correct.

Special Internal Revenue Code Section 401(a)(4) Considerations and Employer Matching Contributions: In dealing with the nondiscrimination requirements of Internal Revenue Code Section 401(a)(4), there are two major concerns for an employer. First, the right to each rate of allocation of employer matching contributions is considered to be a protected benefit, right, and feature of the plan and must be available to a nondiscriminatory group of employees.²⁴ These nondiscriminatory requirements are met if the right to receive a level of employer matching contributions is available to employees in a way that satisfies both the current availability and effective availability standards.²⁵

The right to receive a level of employer matching contributions will be treated as currently available to a group of employees if the group satisfies the minimum coverage requirements of Internal Revenue Code Section 410(b) without regard to the average benefit percentage test previously discussed. An employee is deemed to be benefiting only if the right is currently available to that employee.²⁶

A right to receive a particular level of employer matching contributions is treated as effectively available to a group of employees that does not favor highly compensated employees from all facts and circumstances. For example, if a level of employer matching contributions is only available to those employees with specified years of service or contribution level, it would not be treated as effectively

available if most employees receiving this level are highly compensated employees.²⁷

In addition, an employer may be faced with the nondiscrimination problems under Internal Revenue Code Section 401(a)(4), when amounts of excess contributions (salary deferrals), excess deferrals, or excess aggregate contributions (employer matching contributions and employee after-tax contributions) are distributed. If a corresponding reduction of employer matching contributions is not realized, then highly compensated employees could receive a higher level of employer matching contributions.

These excess employer matching contributions can be cured by either forfeiting these contributions back to the plan and reallocating them to other participants or distributing them directly to participants.²⁸

An employer matching contribution excess can be distributed from a plan merely because it relates to an excess aggregate contribution, deferral, or contribution. To be distributable to a participant, it must be an excess aggregate contribution.²⁹ If an employer matching contribution excess is distributed under the general plan qualification rules applicable to the type of plan (e.g., attainment of age 59½ for profit sharing and stock bonus plans), then that distribution, even if timely, would still be taken into account for Internal Revenue Code section 401(a)(4) purposes. The distribution would not correct any failure to satisfy a nondiscrimination requirement, including a discriminatory rate of match.³⁰

If an excess employer matching contribution is not considered part of an excess aggregate contribution or distributable under the general plan qualification rules, then these excess matching contributions are forfeitable and reallocated to other participants in the plan in the current plan year or the succeeding plan year.³¹

DESIGNED SAFE HARBORS

Introduction: An employer can avoid having to conduct the Actual Deferral Percentage test and the Actual Contribution Test by meeting the requirements for designed safe harbors under Internal Revenue Code Sections 401(k)(12) and 401(m)(11). To meet the designed safe harbor requirements, the employer must contribute designated levels of matching or other employer contributions, 100% vest these employer contributions, subject them to distribution limits similar to salary deferral contributions and give a notice to participants indicating that these contributions will be made.³²

Minimum Employer Contributions: An employer must make minimum employer contributions to eligible non-highly compensated employees to satisfy the designed safe harbor requirements. A plan can be amended to avoid just the Actual Deferral Percentage Test or to avoid both the Actual Deferral Percentage Test and the Actual Contribution Percentage Test. An employer must make contributions to the plan no later than 12 months after the close of the plan year. The contribution requirement may be satisfied by either using a matching contribution formula or a non-elective contribution formula. An employer cannot require a participant be employed on the last day of the plan year or impose a 1000 hour requirement to receive either safe harbor contribution. Therefore to receive either contribution, an eligible participant does not have to work the entire year. Prior to the plan year that the safe harbor formula applies, the employer must amend the plan to provide for the formula. If an employer decides to use the non-elective employer formula, it can amend the plan as late as 30 days prior to the last day of the plan year. In giving the required notice, as explained below, the employer will satisfy the notice requirement if it informs participants that the plan may be amended to provide a non-elective safe harbor contribution of three percent of compensation. In addition the notice must state that the employer will provide a supplemental notice at least 30 days prior to the last day of the plan year.³³

An employer can use a “basic matching formula” to make contributions to non-highly compensated employees to satisfy the Actual Deferral Percentage test designed safe harbor. This contribution must be equal to:

- 100% of the participant's salary deferral contribution, to the extent that these contributions do not exceed 3% of the participant's compensation; and

- 50% of the participant's salary deferral contributions, to the extent that the salary deferral contributions exceed 3%, but do not exceed 5% of the participant's compensation.³⁴

An employer may also satisfy the designed safe harbor requirement by using a "enhanced matching formula." Under this formula, the employer may make matching contributions at any rate of the salary deferral contributions, but in the aggregate the matching contributions must equal or exceed those under the basic formula and the rate of matching contributions must not increase as the rate as a participant's rate of salary deferrals increases. An example of such a formula is 100% of salary deferral contributions up to 4% of compensation. In no event can the rate of matching contributions for any highly compensated employee exceed that of any non-highly compensated employee with the same rate of salary deferral contributions. A matching contribution formula that varies the level of match according to the participant's year of service will not meet this requirement.³⁵

In using either matching formula, an employer can require that participants make salary deferral contributions in whole percentages or in whole dollar amounts.

In making matching contributions, an employer must determine whether it will do so on an annual or payroll-by-payroll basis. If an employer decides to use the payroll method, it must make contributions to the plan no later than the last day of the following plan year quarter.³⁶

An employer who adopts a matching formula may eliminate or reduce matching contributions on a prospective basis. To take advantage of this option, the employer must provide a supplemental notice to all eligible participants, explaining the consequences of plan amendment and giving participants a reasonable opportunity to change their salary deferral or employee contribution elections. This amendment's effective date must be at least 30 days from the date of the notice and the employer must provide in the plan amendment that the plan will pass the nondiscrimination test for the entire plan year, using current-year testing method.³⁷

An employer may also satisfy the design safe harbor requirements by making a contribution equal to at least 3% of compensation for each eligible participant.³⁸ In determining this contribution, an employer is not allowed to utilize permitted disparity, age-weighting or other methods available to vary contributions from other than a designed percentage of compensation formula.³⁹

Other Employer Contribution Issues: An employer may satisfy the designed safe harbor contribution requirement by making contributions to another plan other than the safe harbor 401(k) plan. This requirement is met if the contributions are 100% vested and subject to the same distribution restrictions as salary deferral contributions. In addition the employer must also meet the notice requirements that will be discussed below.⁴⁰

When determining contributions under either safe harbor formula, the compensation definition under the plan must meet one of the definitions under Internal Revenue Code Section 414(s). An employer may limit the period used to determine compensation to the plan year to that portion of the year in which the employee is eligible to participate, so long as that limit is applied uniformly to all eligible participants.⁴¹

The same rules that were discussed earlier for aggregation and disaggregation of plans applies to plans with safe harbor formulas.⁴²

Avoiding the ACP Test: A plan is deemed to meet the Actual Contribution Test for a plan year, if for the entire plan year, each non-highly compensated employee participant eligible to receive a matching contribution is also eligible for a salary deferral that satisfies the Actual Deferral Percentage test safe harbor and the plan limits required matching contributions in one of the following ways. The plan uses:

- A basic match formula and no other matching contribution is made;
- An enhanced matching contribution formula and such contributions do not exceed 6% of compensation and no other matching contributions are provided under the plan; or

- A combination of matching contribution formula and a non- elective formula that does not exceed 6% of compensation in the aggregate.⁴³

To avoid the Actual Contribution Percentage Test, an employer must limit the amount of discretionary matching contribution it makes to the plan. A plan will fail to satisfy the Actual Contribution Percentage Test if discretionary matching contributions on behalf of an eligible participant could exceed a dollar amount equal to 4% of the participant's compensation.⁴⁴

Notice Requirements: To satisfy the design-based safe harbor requirements, each participant must, within a reasonable period before any year, be given written notice of the participant's rights and obligations under the plan in a manner that is sufficiently accurate, comprehensive to apprise the participant of its rights and obligations under the plan, and written in a manner calculated to be understood by the average eligible employee.⁴⁵

A notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes:

- the safe harbor matching or non-elective contribution formula used under the plan (including a description of the levels of matching contributions, if any, available under the plan);
- any other contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;
- the plan to which safe harbor contributions will be made (if different than the plan containing the salary deferral provisions);
- the type and amount of compensation that may be deferred under the plan;
- how to make cash or deferred elections, including any administrative requirements that apply to such elections;
- the periods available under the plan for making cash or deferred elections; and
- withdrawal and vesting provisions applicable to contributions under the plan.⁴⁶

In addition, a plan will not fail the notice content requirement if the notice cross-references relevant portions of an up-to-date summary plan description that has been provided (or concurrently is provided) to the employee. However, the notice still must describe accurately (1) the safe harbor matching or non-elective contribution formula used under the plan (including a description of the levels of matching contributions, if any, available under the plan) and state that these contributions (as well as elective contributions) are fully vested when made and (2) how to make cash or deferred elections (including any administrative requirements that apply to such elections) and the periods available under the plan for making such elections. In addition, the notice also must provide information that makes it easy for eligible employees to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of the individuals or offices from which employees can obtain such plan information.⁴⁷

A notice satisfies the reasonable time requirement if at least 30 days (and no more than 90 days) before the beginning of each plan year, the notice is given to each eligible participant for the plan year. In the case of a participant who does not receive the notice within such period because the participant becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the participant becomes eligible (and no later than the date the participant becomes eligible).⁴⁸

Until IRS and the Treasury Department complete a review of the legal and policy issues relating to the satisfaction of the safe harbor notice requirements through the use of electronic media, a plan will not fail to satisfy the notice requirements outlined in Notice 98-52 with respect to an employee, if the employee

received the notice through "an electronic medium reasonably accessible to the employee," provided that:

- the system under which the electronic notice is provided is reasonably designed to provide the notice in a manner no less understandable to the employee than a written paper document; and
- the employee is advised that the employee may request and receive the notice on a written paper document at no charge, and, upon request, that document is provided to the employee at no charge.⁴⁹

CONCLUSION

From the above discussion, it is apparent that nondiscrimination testing is a complex and time consuming exercise. Over the past five years, the Congress has made efforts to ease this burden by amending the Internal Revenue Service to add prior year testing and designed safe harbors, and to eliminate the multiple use test, but each of these new features carries with it drawbacks as was indicated in Part 2. If an employer adopts the prior year testing method to conduct the Actual Deferral Percentage Test and the Actual Contribution Percentage Test, it has to wait a year to take advantage any positive law changes, plan amendments or demographic changes. An employer can switch to current year testing at any time, but may be prevented from switching to prior year testing in the future if it does not meet one of many requirements. In adopting the designed safe harbors of its plan, an employer must weigh the elimination of testing with the added cost of the required minimum employer contributions and the administrative cost of meeting the notice requirements.

Lastly, over the past several years, the Internal Revenue Service has promised new regulations under Code Sections 401(k) and 401(m). Since these regulations were issued in the early 1990's, many sections have been changed by subsequent legislation and the Internal Revenue Service has changed their position on several issues. It will be interesting to see what changes will be waiting for employers to use in the administration of their plans.

FOOTNOTES

1. Treas. Reg. §1.410(b)-3(a)(2)(i)
2. Treas. Reg. §1.401(m)-1(f)(4)(i)
3. Treas. Reg. §1.410(b)-7(c)(1)
4. Treas. Reg. §1.410(b)-5(d)(3)
5. Treas. Reg. §1.401(m)-1(b)(4)
6. Treas. Reg. §1.401(m)-1(b)(5)
7. Code §401(m)(3) and Treas. Reg. §1.401(m)-1(f)(2)
8. Treas. Reg. §1.401(m)-1(b)(1)
9. Treas. Reg. §1.401(m)-1(f)(1)(ii)
10. IRS Notice 98-1
11. Treas. Reg. §1.401(m)-1(b)(3)(i)
12. Code §401(m)(5)(c)
13. Code §401(m)(6)(B)
14. Code §401(m)(6)(C)
15. Treas. Reg. §1.401(m)-(e)(3)
16. Treas. Reg. §1.401(m)-1(b)(5)
17. Treas. Reg. §1.401(m)-2(b)(1)
18. Treas. Reg. §1.401(m)-2(b)(1)(ii)
19. Treas. Reg. §1.401(m)-2(b)(3)(i)
20. Treas. Reg. §1.401(m)-2(c)(1)
21. Treas. Reg. §1.401(m)-2(c)(3)
22. Treas. Reg. §1.401(m)-2(b)(1)(ii)
23. Treas. Reg. §1.401(m)-2(b)(1)(ii)
24. Treas. Reg. §1.401(a)(4)-4(e)(3)(iii)(G)
25. Treas. Reg. §1.401(a)(4)-4(a)
26. Treas. Reg. §1.401(a)(4)-4(b)(1)
27. Treas. Reg. §1.401(a)(4)-4(c)(1)
28. Treas. Reg. §1.401(m)-1(e)(4)
29. Treas. Reg. §1.401(m)-1(e)(3)(vii)
30. Treas. Reg. §1.401(m)-1(e)(4)
31. Treas. Reg. §1.401(m)-1(e)(4)
32. Code §401(k)(12) and 401(m)(11)
33. IRS Notice 98-52, as modified by IRS Notice 2000-3
34. IRS Notice 98-52
35. Code §401(k)(12)(B)(iii)
36. IRS Notice 2000-3
37. IRS Notice 2000-3
38. Code §401(k)(12)(C)
39. Code §, 401(k)(12)(E)(ii), IRS Notice 98-52
40. IRS Notice 2000-3
41. IRS Notice 98-52
42. IRS Notice 98-52
43. IRS Notice 98-52
44. IRS Notice 98-52
45. IRS Notice 98-52
46. IRS Notice 98-52
47. IRS Notice 98-52
48. IRS Notice 98-52
49. IRS Notice 98-52