

# ***401(k) Plans***

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# 401(k) Plans

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## *401(k) Plans*

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### **I. QUALIFICATION REQUIREMENTS FOR 401(k) PLANS**

#### **A. 401(k) Plan Introduction.**

1. A §401(k) cash or deferred compensation plan is a type of profit-sharing plan under which employees may elect to defer a portion of their compensation to the plan. An individual can defer a maximum of \$16,500 to a §401(k) plan for 2009. Employees who have attained age 50 are permitted to defer additional "catch-up" contributions of \$5,500 for 2009.
2. In addition to satisfying the requirements applicable to a regular profit-sharing plan, a 401(k) plan must satisfy the Average Deferral Percentage ("ADP") Test under IRC §401(k)(3)(A) for each plan year. The ADP consists of two alternative tests which measure the deferral of income of highly-compensated employees in comparison to the deferral of all other employees.

Under the ADP limits, the ADP for the eligible highly compensated employees must be no greater than one of two limits. Under one limit, the ADP for Highly Compensated Employees ("HCEs") is limited to 125% of the ADP for the eligible non-highly compensated employees. Under the second limit, the ADP for HCEs is limited to the lesser of 200% of the ADP for the eligible non-highly compensated employees; or the ADP for the eligible non-highly compensated employees plus two percentage points.

A "highly compensated employee" ("HCE") under IRC §414(q) is an employee who is either a 5% owner (during either the current year or the prior year) of the employer or who has compensation greater than \$105,000 (during the prior year; \$110,000 for 2009) from the employer.

#### **B. General Qualification Requirement.**

1. A 401(k) plan is qualified under 401(a) if it satisfies the qualification requirements applicable to all profit-sharing or stock bonus plans, and has provisions providing for the following three requirements.
  - a. Participants may elect to have a portion of their salary deferred to the qualified trust;

b. Amounts so contributed may only be distributed upon retirement, death, severance from employment, disability, hardship, the attainment of age 59½, or the termination of the CODA plan; and

c. The amounts so contributed under the CODA must at all times be fully vested.

I.R.C. § 401(k)(2); Reg. § 1.401(k)-1.

2. Employee elective deferrals and qualified nonelective contributions are subject to the distribution restrictions noted above. Contributions other than elective deferrals or qualified nonelective contributions are subject to standard profit-sharing plan distribution rules.

C. Special Qualification Rules for 401(k) Plans.

401(k) plans are subject to the following plan rules.

1. The eligibility requirement cannot require more than one year of service;

2. Elective contributions must meet a special non-discrimination test (the actual deferral percentage (ADP) test);

3. Matching contributions and employee nondeductible contributions must meet a special non-discrimination test called the actual contribution percentage (ACP) test;

4. The elective contributions each individual participant can make cannot exceed the annual dollar limitation (\$16,500 for 2009); and

5. The elective contributions must be 100% vested at all times.

## II. 401(k) PROVISIONS UNDER EGTRRA

A. Elective Deferral Limitations.

The dollar limit on annual elective deferrals to 401(k) plans, 403(b) annuities, and salary reduction SEPs was increased to \$11,000 in 2002. In 2003 and thereafter, the limits are increased in \$1,000 annual increments until the limits reach \$15,000 in 2006, with indexing in \$500 increments thereafter (\$16,500 for 2009). The maximum annual elective deferrals that may be made to a SIMPLE plan was increased to \$7,000 in 2002. In 2003 and thereafter, the SIMPLE plan deferral limit was increased in \$1,000 annual increments until the limit reached \$10,000 in 2005. Beginning after 2005, the \$10,000 dollar limit is indexed in \$500 increments (\$11,500 in 2009). (Act Section 611 amending IRC Section 402(g))

B. Additional Salary Reduction Catch-up Contributions.

Effective for taxable years beginning after December 31, 2001, the otherwise applicable dollar limits on elective deferrals for a 401(k) plan, a 403(b) annuity, SEP, or SIMPLE or deferrals under an eligible 457 plan are increased for individuals who have attained at least age 50 by the end of the year. The additional amount of elective contributions that may be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount (see table below) or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year. (Act Section 631 adding IRC Section 414(v))

Note: A Plan permitting catch-up contributions cannot restrict elective deferrals to less than 75% of a participant's compensation. Treas. Reg. § 1.414(v)-1(e)(ii)(B).

- i. Catch-up amount for 401(k), 403(b), SEP or 457 Plan; 2002: \$1,000; 2003: \$2,000; 2004: \$3,000; 2005: \$4,000; 2006-2009: \$5,000 (adjusted \$5,500 for 2009).
- ii. Catch-up amount for SIMPLE; 2001: \$500; 2003: \$1,000; 2004: \$1,500; 2005: \$2,000; 2006 and thereafter: \$2,500.

C. Faster Vesting of Employer Matching Contributions.

In 2001, a plan must vest a participant's matching contributions using either a 5-year cliff vesting schedule or a 3 to 7 year graded vesting schedule. Effective for contributions for a plan years beginning after December 31, 2001 (with a delayed effective date for plans maintained pursuant to a collective bargaining agreement), faster vesting schedules will apply to employer matching contributions. A plan must use either a 3-year cliff vesting schedule or a 2 to 6 year graded vesting schedule with 20% annual increments. (Act Section 633 amending IRC Section 411(a))

D. Hardship Distributions.

For plans using the IRS's safe harbor hardship rules to determine immediate and heavy financial need, the IRS is directed to revise its regulations to provide that the period an employee is prohibited from making elective and employee contributions is reduced to 6 months (previously 12 months). The revised regulation will apply to years beginning after December 31, 2001. In addition, the Act provides that an eligible rollover distribution will not include any distribution, which is made upon hardship of the employee, not just those made with respect to elective deferrals. (Act Section 636 amending Treas. Reg. Section 1.40(k)-1(d))

E. 401(k) and 401(m) Multiple Use Test Repealed.

The multiple use test for 401(k) and 401(m) plans is repealed for plan years beginning after December 31, 2001. (Act Section 666 amending IRC Section 401(m)(9))

F. Repeal of "Same Desk" Rule.

Prior to 2002, distributions may not be made from a 401(k) plan, 403(b) annuity, or 457 plan prior to the occurrence of certain events, such as "separation from service." Under the "same desk" rule, separation from service occurs only upon death, retirement, resignation, or discharge, and not when an employee continues service at the same job for a different employer as the result of a merger or liquidation. Effective for distributions after December 31, 2001, the same desk rule is repealed and, distributions from 401(k) plans, 403(b) annuities, and eligible 457 plans may occur upon "severance from employment" rather than "separation from service." (Act Section 646 amending IRC Section 401(k))

G. Restrictions on Investment of Elective Deferrals in Qualifying Employer Securities and Qualifying Employer Real Property.

The Taxpayer Relief Act of 1997 extended the 10% limitation on investments in qualifying employer securities and qualifying employer real property under ERISA Section 407(a) to elective deferrals under Section 401(k) plans. Under EGTRRA, this change will not apply to any elective deferral, which is invested in assets consisting of qualifying employer securities, qualifying employer real property, or both, if such assets were acquired before January 1, 1999. (Act Section 655 amending ERISA Section 407)

H. 401(k) Coverage Test Relief for Tax Exempt Organizations.

Coverage testing relief has been granted to enable tax exempt employers with for-profit subsidiaries to sponsor a 403(b) tax sheltered annuity and a 401(k) plan or a 401(m) plan if (1) no employee of such charitable tax exempt entity is eligible to participate in the 401(k) or 401(m) plan, and (2) at least 95% of the employees who are not employees of the tax exempt charitable employer are eligible to participate in the Section 401(k) or 401(m) plan. (Act Section 664 amending Treas. Reg. 1.410(b)-6(g))

I. Final Regulations for 401(k) Plans.

Final Treasury Regulations Sections 1.401(k)-1 through 1.401(k)-6 and Sections 1.401(m)-1 through 1.401(m)-5 were issued December 29, 2004. The regulations are effective for plan years beginning on or after January 1, 2006.

- i. "Targeted" QNECs and QMACs. The regulations limit the use of "targeted" qualified nonelective contributions (QNECs) and qualified

matching contributions (QMACs) thereby restricting the use of "bottom up" QNECs. In general, QNECs for any one employee that could be included in the ADP or ACP test would be the greater of 5% or twice the plan's representative contribution rate (generally, the lowest NHCE contribution rate, taking into account a sampling of NHCEs that equals at least 50% of the total eligible NHCEs).

The limit placed on the amount of the QNEC allowed under the ADP test is independent of the amount allowed under the ACP test. Therefore, a QNEC of 10% of a participant's pay may be utilized for testing purposes by using 5% of pay for the ADP test and 5% of pay for the ACP test.

- ii. Disproportionate match allocated to NHCEs. The ACP test will not include matching contributions for NHCEs which exceed the greater of 100% or twice the plan's representative matching rate. Similarly, disproportionate matching contributions will not be permitted to be used as QMACs under the ADP test.
- iii. Timing of QNECs under prior year tested plans. QNECs for prior year tested plans must be contributed by the end of the testing plan year.
- iv. Corrective distributions. Gap period earnings on excess contributions under the ADP test and excess aggregate contributions under the ACP test would be required if the plan credited earnings during gap period (for example, in a daily valued plan). Replaced effective in 2008 by PPA.
- v. Plans with only eligible HCEs. The regulations provide that, if a plan uses the prior year testing method and the only eligible employees are HCEs for such prior plan year, the plan is deemed to pass the ACP/ADP tests.
- vi. ESOPs. Current rules that require the disaggregation of ESOPs and non-ESOPs for ADP and ACP testing will be eliminated.
- vii. Catch-Up Contributions. A plan with a plan-imposed deferral limitation of less than 75% of compensation will violate the universal applicability requirements for catch-up contributions. Treas. Reg. Section 1.414(v)-1(e)(ii)(B).
- viii. Plan Amendments Required. All 401(k) plans were required to be amended for compliance with the final regulations by the last day of the 2006 plan year.

### **III. SPECIAL TYPES OF 401(K) PLANS**

#### **A. Roth 401(k) Contributions.**

- 1. Effective for Plan Years commencing on or after January 1, 2006, Plan Sponsors may amend 401(k) or 403(b) plans to permit plan

participants to elect to treat some or all of their elective deferrals as contributed on a Roth basis. The amendment must be adopted by the last day of the plan year in the calendar year that Roth deferrals are permitted.

IRS Notice 2006-44 provides a sample plan amendment for Roth contributions for a 401(k) plan.

2. If the Plan so permits, participants will be able to elect to have all or a portion of elective deferrals on or after January 1, 2006 as being deferred into the 401(k) plan on an after-tax basis. Future distributions from the Roth 401(k) account would be distributed on a tax-free basis (similar to a Roth IRA). Thus, a participant under Age 50 could defer up to \$16,500 into the 401(k) plan on a Roth basis in 2009. Participants Age 50 or older could also have catch-up contributions treated on a Roth-type basis for total deferrals of \$22,000 in 2009 (*i.e.*, the normal 401(k) deferral limits).
3. The Roth treatment only applies to the Participant's elective deferrals. Employer matching contributions or employer non-elective contributions will continue to be treated as tax-deferred contributions and will be taxable to the participant when distributed from the Plan.
4. Unlike Roth IRA assets, Roth 401(k) accounts will continue to be subject to the minimum distribution rules under IRC Section 401(a)(9).
5. Any excess deferrals attributable to a designated Roth contribution must be distributed no later than April 15 of the year following the year of the designated Roth contribution. If the excess deferrals are not distributed by April 15, the contribution will be taxed both in the year of contribution and the year of distribution (*i.e.*, subject to double taxation), however, earnings attributable to the excess Roth deferral are only taxed in the year of distribution.
6. Roth 401(k) Contribution Compliance.
  - a. Roth contributions are taxed at the time of the contribution and only earnings, if not qualified, are subject to future income taxes.
  - b. There is still one annual limit for deferrals which includes both Roth and traditional deferrals. The limit for 2009 is \$16,500 (\$22,000 for participants age 50 or older).
  - c. Traditional 401(k) and Roth (401(k) deferrals are tested together in the ADP test.

- d. Both contribution types will be treated the same when applying a match formula. All matching contributions are tested together in the ACP test. There is no special tax treatment for matching contributions attributed to Roth 401(k) contributions since these are still considered employer contributions.
  - e. Separate recordkeeping accounts for Roth 401(k) and Traditional 401(k) deferrals are required.
  - f. The amendment to the plan document will need to specify if the participant has the option between Roth 401(k) and Traditional 401(k) contributions or a mix of both, and whether the participant has a choice as to the source from which compliance refunds should be taken.
7. Roth 401(k) Distribution Rules.
- a. Distributions are subject to the same restrictions as traditional 401(k) contributions — i.e., hardship distributions from contributions only and in-service distributions only allowed after attainment of age 59½.
  - b. The portion of the account attributable to Roth 401(k) contributions is always tax free upon distribution.
  - c. Earnings are tax free only if the participant is either age 59½, disabled or deceased AND the first Roth 401(k) contribution was deposited five or more tax years ago. (If the plan allows Roth 401(k) rollovers, this would include the date the first Roth 401(k) contribution was made to the prior plan.) Roth 401(k) earnings can be distributed tax free as early as 2011 under these rules.
  - d. The Plan Sponsor is responsible for tracking the five years and the basis on the contributions to determine the tax that may be due upon distribution, even on rollover Roth 401(k) contributions.
  - e. The five-year period is based on tax years, not the elapsed time from the first contribution.
  - f. Unlike the Roth IRA, withdrawals are taken out pro-rata between contributions and earnings. Participants cannot choose to take only contributions first for non-qualified distributions.
  - g. Tacking Years for Roth 5-Year Holding Period.

- i. Rollover FROM Roth 401(k) or Roth 403(b) INTO Roth 401(k) or Roth 403(b): Years from prior Roth plan are included to determine 5-year period.
  - ii. Rollover FROM Roth 401(k) or Roth 403(b) INTO Roth IRA: Years from Roth plan are NOT included for determining 5-year period in Roth IRA. Roth IRA and Roth plan have separate 5-year periods.
  - iii. Rollovers FROM Roth IRAs are not permitted (except to another Roth IRA).
8. Roth 401(k) Final Regulations

Final regulations were issued January 3, 2006 to amend the final 401(k) and 401(m) regulations issued on December 29, 2004 to incorporate rules for Roth 401(k) contributions.

1. Election Requirements

A designated Roth contribution is an elective contribution that, to the extent permitted in the plan, is designated irrevocably by the employee, at the time of the cash or deferred election, as a Roth contribution that is being made in lieu of all or a portion of the pre-tax elective contributions the employee is otherwise eligible to make under the plan. Reg. §1.401(k)-1(f)(1). The reference to the designation being made "in lieu of" pre-taxed elective contributions was added by the final regulations to clarify that a plan may not limit the character of elective contributions to Roth only.

An employee must have an opportunity to make or change an election to make designated Roth contributions at least one time during each plan year.

A plan which provides for automatic enrollment and which also provides for a Roth designation feature must specify the extent to which the default contributions are pre-tax or Roth. Reg. §1.401(k)-1(f)(4)(ii)(A).

2. Separate Accounting.

The plan must separately account for the Roth contributions in earnings thereon. Reg. §1.401(k)-1(f)(2).

3. No Forfeiture Allocations.

A designated Roth contribution account may not receive an allocation of forfeitures.

4. Tax Treatment at Time of Contribution.

When an employee's elective deferrals are designated as Roth contributions, the employer must treat such amount as includable in gross income. Reg. §1.401(k)-1(f)(1)(ii).

5. Refund of Excess Contributions.

If a highly-compensated employee is receiving a distribution of excess contributions due to the plan's failure of the ADP test, and the HCE has designated the elective deferrals as Roth contributions, the amount returned will be includable in gross income only to the extent the corrective distributions includes income on the Roth contributions being distributed. Reg. §1.401(k)-2(b)(2)(vi)(C).

6. Elective Deferral Treatment for All Plan Purposes.

With the exception of the separate tax rules applicable to Roth 401(k) contributions, Roth contributions are treated in all other respects as elective deferrals, in the same fashion as pretax elective deferrals. Reg. §1.401(k)-1(f)(3)(i).

7. Minimum Distribution Rules.

Roth 401(k) contributions are subject to the minimum distribution requirements under IRC §401(a)(9) in the same manner as pretax elective deferrals. Reg. §1.401(k)-1(f)(3)(i).

9. Roth IRA Alternative. Elimination of \$100,000.00 AGI limit for Roth IRA Rollover (effective in 2010).

- a. TIPRA eliminates the current \$100,000.00 adjusted gross income (AGI) ceiling for converting traditional IRAs to Roth IRAs, for tax years after 2009. A conversion is treated as a taxable distribution, but is not subject to the 10% early withdrawal penalty. Taxpayers who convert in 2010 can elect to recognize the conversion income in 2010 or average it over the next two years.
- b. Planning Opportunity. Individuals may wish to contribute non-deductible contributions to IRAs for 2006-2010 and rollover the IRA to a Roth IRA in 2010.

B. Safe Harbor §401(k) Plan.

IRC §401(k)(12); IRS Notice 98-52; IRS Notice 2000-3.

1. Safe Harbor Non-Discrimination Rules. A 401(k) plan satisfies the non-discrimination rules (the ADP test) if it meets the following requirements:
  - a. a notice requirement; and
  - b. one of two contribution requirements (discussed below).
2. The notice requirement is met if each employee eligible to participate in the Plan is given written notice (prior to the plan year) of his rights and obligations under the plan. The notice must be given between 30 and 90 days before the beginning of the plan year.
  - a. For an employee who becomes eligible later than the 90th day before the beginning of the plan year, the notice may be given not later than the employee's date of eligibility.
  - b. With respect to a new plan, the notice can be given up to the first day of the first plan year.
  - c. Please note, the IRS has stated that if the safe harbor is blown (e.g., the notice is not provided), the plan is disqualified. It does not merely revert to a 401(k) plan subject to ADP testing.
3. Basic Formula. The contribution requirement is met under the safe harbor if the employer provides a matching contribution on behalf of each Non-Highly Compensated Employee of (i) 100% of the employee's elective contributions up to 3% of compensation and (ii) 50% of the employee's elective contributions to the extent that they exceed 3% (but not 5%) of the employee's compensation. Additionally, the rate of the matching contributions with respect to any elective contribution for highly compensated employees is not greater than the rate of match with respect to non-highly compensated employees.
  - a. Alternatively, the matching contribution safe harbor may be met if the rate of the employer's matching contribution does not increase as the employee's rate of elective contributions increases and the total amount of matching contributions is at least equal to the requirements set out above (e.g., 100% of the contributions up to 3% of compensation and 50% of contributions between 3% and 5%).

- b. Enhanced Formula. An enhanced formula provides a match that is at least equal to the amount of the match that would be made under the basic formula. A match of 100% of the first 4% deferred is an acceptable enhanced formula.
4. In lieu of a matching contribution, the employer may make a non-elective contribution of at least 3% of an employee's compensation to a defined contribution plan on behalf of each non-highly compensated employee who is eligible to participate in the plan regardless of whether the employee makes an elective contribution.
5. 100% Vesting Required. The employer matching safe harbor contributions must be non-forfeitable and subject to the restrictions on withdrawals that apply to elective deferrals.
6. Last Day of Plan Year And 1,000 Hour Requirements Not Permitted. The employer safe harbor matching or non-elective contribution for a plan year cannot be made subject to a requirement that the participant is employed in the last day of the plan year or that the participant completes 1,000 hours of service during the plan year.
7. Definition of Compensation. A safe harbor matching contribution formula or a safe harbor nonelective contribution formula must use a definition of compensation that satisfies IRC §414(s). The plan is permitted to use partial-year compensation for newly eligible employees.
8. Document Requirements. A plan must specify the formula requirement (the matching contribution or the nonelective contributions). As a general rule, a plan may not rely on the safe harbor unless the plan document reflects such requirements before the first day of the plan year. However, the remedial amendment period rules are applied by Notice 98-52 to the plan document requirements for the safe harbors.
9. Plan Year Requirements. Plans may not rely on the safe harbors for a plan year unless the plan year is 12 months long. For a new plan, however, (other than a successor plan) the first plan year may be less than 12 months, but must be at least 3 months. A new plan for a newly established employer may be less than the 3-month minimum. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible under another 401(k) plan of the employer in the prior year. IRS Notice 98-1.

Treasury regulations would allow a short plan year in additional circumstances:

- When the plan terminated, if the plan termination was in connection with a merger or acquisition involving the employer, or the employer incurred a substantial business

hardship comparable to a substantial business hardship described in Section 412(d);

- When the plan terminated, provided the employer made safe harbor contributions for the short year, employees were provided notice of the change, and the plan passed the ADP test; and
- Where the short plan year was preceded and followed by 12-month plan years during which the plan was a safe harbor plan.

10. Amendment of Existing Plan. Notice 2000-3 allows a non-safe harbor 401(k) plan that uses the current year testing method to be amended into a safe harbor plan as late as 30 days before the end of the plan year. The safe harbor contribution must be in the form of a 3% nonelective contribution and two notices must be given. First, eligible employees must receive notice before the beginning of the plan year advising them that the plan sponsor may choose to amend the plan into a safe harbor plan. Second, a notice of the amendment must be given to participants at least 30 days before the end of the plan year.
11. Amendment of Profit-Sharing Plan to Add Safe Harbor Provisions. Under Notice 2000-3, a profit-sharing plan can be amended to add safe harbor 401(k) features up to three months before the end of the plan year as long as the plan is not a successor plan (as defined in Notice 98-1), the cash or deferred elections begin not less than three months prior to the end of the plan year and the requirements of Notice 98-52 are otherwise satisfied for the period during which deferral elections are permitted.
12. Suspension of Safe Harbor Matching Contributions. A safe-harbor plan is permitted to prospectively suspend or reduce matching contributions and to discontinue safe harbor status. The suspension of safe harbor matching contributions cannot take effect earlier than the later of 30 days after (i) the participant notice is given or (ii) the date the plan is amended. The plan must then satisfy the ADP test using the current year method based on contributions for the entire year. Notice 2000-3.
13. Suspension of Safe Harbor Nonelective Contributions. Treasury Prop. Reg. §§1.401(k)-3(g); 1.401(m)-3(k), effective May 18, 2009.
  - a. Employer may amend the plan to suspend or reduce safe harbor nonelective contributions without terminating the §401(k) plan.
  - b. The employer must provide a Notice to plan participants at least 30 days prior to the cessation of the nonelective contribution.

- c. Plan must be amended to cease nonelective contributions and to apply current year ACP/ADP testing.
  - d. The employer must have a "substantial business hardship" (as defined in IRC §412(c)(2)). Relevant factors:
    - i. Employer is operating at an economic loss;
    - ii. Substantial unemployment or underemployment in the trade or business and in the industry;
    - iii. Sales and profits of the industry concerned are depressed or declining; and
    - iv. Reasonable to expect plan will not continue unless the amendment is made.
  - e. Lose top-heavy exemption.
14. Safe Harbor Contribution May Be Provided to a Separate Plan. If the contribution is made to a separate plan, the other plan must have the same plan year as the 401(k) plan.
  15. Current Year Testing Method is Deemed to Apply to Safe Harbor Plans. This will impact the plan's ability to switch to the prior year testing method for any plan year beginning after the GUST remedial amendment period. Notice 98-1 generally requires that a plan use the current year method for at least 5 years before it can switch to the prior year method after the remedial amendment period ends.
  16. Safe harbor contributions may not be used as QMACs or QNCs for other arrangements that need to apply the ADP test or ACP test.
  17. Safe harbor 3% nonelective contribution can count in three ways:
    - a. Replaces and satisfies the ADP/ACP test.
    - b. Satisfies the 3% minimum top-heavy contribution.
    - c. As a profit-sharing contribution that can be taken into account for nondiscrimination testing under IRC §401(a)(4) (other than the permitted disparity/integration rules of §401(l)).
  18. Safe Harbor Matching Contribution Satisfies Top-Heavy Rules. The safe harbor matching contribution is deemed to satisfy the top-heavy rules. This does not mean that an accompanying profit sharing plan automatically satisfies the top-heavy rules, but the matching contribution will count towards the top-heavy minimums. EGTRRA §613 modifying IRC §416 effective for plan years commencing after December 31, 2001. Rev. Proc. 2004-13.

**EXAMPLE I**

**Safe Harbor 401(k) Example (2009)**

				spouse
Compensation:	\$ 50,000	\$ 100,000	\$ 245,000	\$ 25,000
	x .04	x .04	x .04	x .04
Match:	2,000	\$ 4,000	\$ 9,800	\$ 1,000
Deferral:	16,500	\$ 16,500	\$ 16,500	\$ 16,500
Subtotal:	18,500	\$ 20,500	\$ 26,300	\$ 17,500
Catch-Up (Age 50)	5,500	\$ 5,500	\$ 5,500	5,500
Total:	\$ 24,000	\$ 26,000	\$ 31,800	\$ 23,000

**EXAMPLE II**

Example Of Cost Of Benefits For NHCEs Under Various Retirement Plan Options To Provide Maximum \$47,000. Contribution For HCE.

a. Highly Compensated Employee (HCE)

Compensation: \$ 245,000  
 Contribution: \$ 49,000  
 Percentage: 20%

b. Non-Highly Compensated Employees (NHCEs)

<u>Retirement Plan Option</u>	<u>Employer Contribution</u>
1. Profit Sharing (Non-Integrated)	20%
2. Profit Sharing (Integrated)*	16.49%
3. Safe Harbor 401(k) (2009: \$16,500) with Integrated Profit Sharing	9.76%
4. Cross Tested Profit Sharing (with optimal demographics)	4.42%

\* Integrated at 5.4% of compensation > 80% of social security taxable wage base + \$1.00

\$ 245,000  
 - 85,441 (\$106,800 x .8 = \$85,440 + \$1)  
 \$ 159,559 x .054 = \$8,616.18 ÷ \$245,000 = 0.0351

19. Safe Harbor Non-Discrimination Rules for §401(m). §401(m)(11).

There is also a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test).

- a. The plan must meet the safe harbor contribution and notice requirements applicable to Section 401(k) arrangements.
- b. The plan must meet the following limitations on matching contributions:
  - i. Employer matching contributions may not be made with respect to employee contributions or elective deferrals in excess of 6% of compensation;
  - ii. The rate of an employer's matching contribution may not increase as the rate of an employee's contributions or elective deferrals increases; and
  - iii. The matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.
- c. Any after-tax employee contributions continue to be tested separately under the ACP Test.

C. 401(k) Automatic Contribution Arrangements: ACAs, EACAs, QACAs

1. Qualified Automatic Contribution Arrangement (QACA); IRC §401(k)(13).
  - a. Effective for plan years commencing on or after January 1, 2008, the 2006 Pension Protection Act (PPA) creates an optional nondiscrimination safe harbor for automatic enrollment plans. Plans satisfying the safe harbors would not have to perform the nondiscrimination tests for employee elective deferrals (ADP) or for matching contributions (ACP) and are exempt from the top-heavy rules.

- b. The safe harbor requires that the automatic enrollment contribution rate be at least:

first year of participation:	3%
second year of participation:	4%
third year of participation:	5%
fourth (or greater) year of participation:	6%

The plan may specify a higher percentage up to 10%.

- c. The QACA must provide a minimum employer matching contribution of 100% of elective deferrals up to 1% of compensation plus 50% of elective deferrals between 1% and 6% of compensation.
- d. As an alternative to the matching contribution, the employer can make a nonelective contribution of 3% of compensation on behalf of each employee eligible to participate in the automatic enrollment feature.
- e. The employer matching contributions or employer elective contributions satisfying the safe harbor must be vested no less rapidly than under 2-year cliff vesting (100% vested after 2 years of service).
- f. The QACA is optional. An employer is still permitted to have an automatic contribution arrangement (ACA) 401(k) plan and test for nondiscrimination under the ADP and ACP tests.
- g. Comparison of 401(k)(12) Safe Harbor to 401(k)(13) QACA.

	<u>401(k)(12) Safe Harbor</u>	<u>401(k)(13) QACA</u>
Employer Match	4%	3.5%
Employer Non-Elective	3%	3.0%
Vesting	Immediate 100%	2 Years/100%

- 2. Eligible Automatic Contribution Arrangement (EACA); IRC §414(w).
  - a. An EACA must meet participant notification requirements providing:
    - i. annual notice to affected employees before the beginning of the year (the requirement that the notice be issued before the beginning of the plan year will

make it difficult to begin automatic enrollment mid year);

- ii. notice of the participant's right to elect out of plan coverage or to change deferral percentages and the time periods for making such elections.
  - b. IRS proposed regulations provide a uniformity requirement for an EACA. Thus, the automatic deferral requirement must be applied uniformly with respect to all eligible plan participants. An EACA may be limited to a specific class of employees. Treas. Reg. §1.414(w)-1(b)(2).
  - c. Plans that notify participants how contributions will be invested and meet certain default investment guidelines will be treated as satisfying ERISA section 404(c) even if a participant does not make an affirmative investment election. If the participant in a EACA does not make an investment election, the automatic deferrals should be invested in a Qualified Default Investment Alternative (QDIA) under ERISA §404(c)(5). However, a QDIA is not mandatory for an EACA.
  - d. One of the advantages of satisfying the EACA requirements is that the plan may permit a participant to withdraw automatic contributions at any time during a 90-day window period without penalty. A plan meeting the EACA requirements can also make corrective distributions to pass nondiscrimination tests within 6 months of year end, rather than 2-1/2 months. Amounts withdrawn or distributed are taxable in the year of receipt. IRC §414(w).
3. State payroll and withholding laws that limit automatic contributions are preempted by ERISA for all ACAs, EACAs and QACAs.
4. 2009 IRS Rulings for ACAs.
  - a. IRS Rev. Ruling 2009-30 provides guidance on how an escalator feature (automatic contribution increases) can operate in an EACA or a QACA.
  - b. IRS Notice 2009-65 provides two sample amendments for adding an ACA or EACA feature to a 401(k) plan.
  - c. IRS Notice 2009-66 provides guidance on including an ACA in a SIMPLE-IRA plan.
  - d. IRS Notice 2009-67 provides a sample amendment for adding an ACA to a SIMPLE-IRA plan.

D. Deduction Limits

1. Impact of Enhanced Deduction Limitations for Plan Contributions under EGTRRA.

IRC §404.

a. Deduction limitation for contributions to profit sharing plans (pre-EGTRRA) (plan years commencing prior to January 1, 2002):

- i. Compensation is defined for §404 purposes as excluding employee elective deferrals.
- ii. Elective deferrals count as employer contributions for purposes of the deduction limitations.
- iii. Deduction limit is 15% of the aggregate compensation of covered employees.

b. Deduction limitation for contributions to profit sharing plans (post EGTRRA) (plan years commencing on or after January 1, 2002):

- i. Compensation is defined for §404 purposes as including employee elective deferrals. IRC §404(a).
- ii. Elective deferrals do not count as employer contributions for purposes of the deduction limitations. IRC §404(n).
- iii. Deduction limit is 25% of the aggregate compensation of covered employees. IRC §404(a)(3).

c. **Example I.** Change in IRC Section 404 Deduction.

<u>2001</u>		<u>2002</u>
\$ 1,000,000	Participant Compensation	\$ 1,000,000
- 100,000	Participant Deferrals	100,000
<u>900,000</u>	Section 404 Compensation	1,000,000
x .15	Section 404 Deduction %	x .25
135,000	Maximum Contribution	250,000
- 100,000	Adjustment for Deferrals	- 0
<u>\$ 35,000</u>	Maximum Employer Contribution	<u>\$ 250,000</u>

2. **Example II.** Maximum Contribution for Corporation with One Plan Participant.

a. Profit-Sharing Without 401(k)

\$ 196,000	Compensation
x     .25	
49,000	Profit-Sharing
+ 196,000	Compensation
\$ 245,000	Total \$ Needed for Maximum Contribution

b. Profit-Sharing With 401(k)

\$ 130,000	Compensation (Including 401(k) Deferral)
x     .25	
32,500	Profit-Sharing
+ 16,500	401(k) Deferral
\$ 49,000	
+ 5,500	Catch-Up Deferral (50 Years of Age)
\$ 54,500	Total Contributions

\$ 130,000	Compensation (Including 401(k) Deferral)
+ 32,500	Profit-Sharing
\$ 162,500	Total \$ Needed for Maximum Contribution

c. Summary for 2009

- Without 401(k): need \$245,000 to contribute \$49,000 to plan.
- With 401(k): need \$162,500 to contribute \$49,000 to plan (\$54,500 if age 50 or older).

3. **Example III.** 50 Year-Old with Self-Employment Income.

\$ 30,000	Compensation
x     .2	
6,000	Profit-Sharing
+ 16,500	401(k) Deferral
22,500	
+ 5,500	Catch-Up Deferral
\$ 28,000	Total Contribution to Plan

#### **IV. 401(k) PROVISIONS UNDER THE PENSION PROTECTION ACT OF 2006 (PPA)**

A. Automatic Enrollment — see III.C. above.

B. Participant Investment Advice

The PPA allows an affiliated fiduciary advisor to provide personal advice to participants if the fees received by the fiduciary do not vary based on the investment options the participants select. Additionally, the PPA allows employers to make advice available through a computer model certified by an independent third party. However, before such advice is given, participants must receive a disclosure that addresses how the fiduciary will be compensated for providing investment advice. These new rules are effective for plan years beginning January 1, 2007.

C. Vesting

Effective January 1, 2007, employer profit-sharing and other non-elective contributions must vest on a three-year cliff or six-year graded schedule (i.e., the same as employer matching contributions under current law).

D. Diversification of Company Stock

Defined contribution plans that hold publicly-traded employer securities must permit participants to diversify the portion of their accounts invested in those securities. Under the PPA, plans must allow participants to immediately diversify their elective deferrals in any after-tax contributions invested in employer securities. Participants with at least three (3) years of service must be allowed to diversify their employer contributions. For employer securities acquired before 2007, the rule is phased in over three (3) years except for participants who are age 55 or older and have three (3) years of service. These rules generally apply to plan years beginning January 1, 2007.

E. Permanence of EGTRRA Provisions

Under EGTRRA, the various enhanced retirement savings incentives would have ended after December 31, 2010. The PPA repeals the 2010 sunset and makes the following EGTRRA provisions related to 401(k) plans permanent:

1. Permanent higher dollar limits on defined contribution plans (\$49,000 in 2008), elective deferrals (\$16,500 in 2009 for 401(k) plan deferrals) and compensation that may be taken into account under a plan;
2. Permanent catch-up contributions for older workers (\$5,500 for 401(k) plans);
3. Permanent Roth 401(k)s;

4. Permanent modifications to the top heavy non-discrimination coverage rules; and
5. Permanent enhanced rollover rules.

**V. TYPES OF CONTRIBUTIONS AND NON-DISCRIMINATION TESTING OF LEVEL OF CONTRIBUTIONS**

A. Types of Contributions.

1. Elective contributions.

Employer contributions to a plan pursuant to an employee's cash or deferred election and which are not treated as after-tax contributions. Reg. § 1.401(k)-1(a)(2); Reg. § 1.401(k)-1(g)(3); Reg. § 1.401(m)-1(f)(3). An elective contribution must be allocated to a participant's account as of a date within the plan year for which the elective contribution is made. Reg. § 1.401(k)-1(b)(4)(i). To satisfy this requirement, the allocation may not be contingent on an employee's participation in the plan or performance of service on any day subsequent to the allocation date. The contribution must be paid to the trust not later than the end of the twelve-month period immediately after the end of the plan year to which the contribution related. Department of Labor regulations require that employee contributions must be contributed to a trust no later than the fifteenth business day of the month following the month in which such wages would otherwise have been payable to the employee. ERISA Reg. § 2510.3-102(b). Failure to contribute within that time frame would be a violation of the ERISA requirement that all plan assets be held in trust. Elective contributing must be 100% vested at all times.

2. Elective deferrals.

Elective contributions to a qualified CODA, salary reduction SEP, SIMPLE Plan or § 403(b) annuity contract. I.R.C. § 402(g)(3).

3. Nonelective contributions.

Employer contributions (other than matching contributions) not subject to a CODA election. Reg. § 1.401(k)-1(g)(10) and Reg. § 1.401(m)-1(f)(13).

4. Matching contributions.

Employer contributions allocated on the basis of the employee's elective contribution. I.R.C. § 401(m)(4)(A); Reg. § 1.401(m)-1(f)(12). A matching contribution may be either mandatory or discretionary. It may be made on an ongoing basis, as deferrals are paid to a trust, or at the end of a plan year. Matching contributions are subject to the ACP test. Contributions or allocations used to meet § 416 top-heavy minimum contribution or benefit requirements are not regarded as

matching contributions. Reg. § 1.401(k)-1(g)(9); Reg. § 1.401(m)-1(f)(12).

5. Qualified nonelective contributions (QNEC).

Employer contributions other than elective and matching contributions, that satisfy the immediate 100% vesting requirements and distribution restrictions applicable to elective deferrals. Reg. § 1.401(k)-1(g)(13)(ii).

6. Qualified matching contributions (QMAC).

Matching contributions which satisfy the 100% vesting requirements and distribution restrictions applicable to elective deferrals. Reg. § 1.401(k)-1(g)(13)(i).

7. Discretionary contributions.

Employer contributions that are allocated on the basis of compensation or in some manner other than on the basis of elective contributions and allocated to a separate account. Discretionary contributions do not need to be included in any of the special non-discrimination tests for 401(k) plans but they are subject to the general non-discrimination requirements under I.R.C. § 401(a)(4). Discretionary contributions may sometimes be used to satisfy the special 401(k) plan non-discrimination tests if certain conditions are met. A participant's right to receive allocation of a discretionary contribution cannot depend on whether they have made elective contributions. I.R.C. § 401(k)(4)(A); Reg. § 1.401(k)-1(e)(6).

B. Actual Deferral Percentage Test (ADP). I.R.C. § 401(k)(3)(A).

1. In addition to satisfying the requirements applicable to a regular profit-sharing plan, a 401(k) plan must satisfy the ADP Test for each plan year. The ADP consists of two alternative tests which measure the deferral of income of highly-compensated employees in comparison to the deferral of all other employees.

2. Under the ADP limits, the ADP for the eligible highly compensated employees must be no greater than at least one of the following limits.

a. 125% limit.

125% of the ADP for the eligible non-highly compensated employees; or

- b. 200%/2% spread limit.

The lesser of:

- i. 200% of the ADP for the eligible non-highly compensated employees; or
- ii. The ADP for the eligible non-highly compensated employees plus two percentage points.

- c. Application of 200% limit.

If the ADP for the non-highly compensated group is 2% or less, the 200% limit applies.

- d. Application of two percent spread limit.

If the ADP for the non-highly compensated group is not less than two percent and not more than eight percent, the two percent spread limit applies.

- e. Application of 125% limit.

If the ADP for the non-highly compensated group is 8% or more, the 125% limit applies.

<b>ADP of Non-Highly Compensated Group</b>	<b>Highly Compensated ADP Limit</b>
1%	2%
2%	4%
3%	5%
4%	6%
5%	7%
6%	8%
7%	9%
8%	10%
9%	11.25%
10%	12.50%

- f. The employer maintaining the plan and all other employers required to be aggregated under I.R.C. §§ 414(b),(c),(m) or (o) are treated as a single employer. Reg. § 1.401(k)-1(g)(6).

- g. Eligible employees include all employees eligible to make a cash or deferred election or employee contribution or to receive an allocation of matching contributions under the plan during a given plan year. Reg. § 1.401(k)-1(g)(4). Employees who upon commencement of employment made a one-time election not to participate under any plan of the employer for the duration

of their employment are not included. Reg. § 1.401(k)-1(g)(4)(ii).

- h. Compensation is governed by I.R.C. § 414(s). Reg. § 1.401(k)-1(g)(2). A plan may limit the compensation taken into account to compensation received by an employee while the employee is a plan participant or may use compensation for the entire plan year.
- i. For the actual deferral ratio, elective contributions include qualified nonelective contributions and qualified matching contributions. I.R.C. § 401(k)(3)(D); Reg. § 1.401(k)-1(g)(13); Reg. § 1.401(k)-1(b)(5).
- j. The ADP for a group of eligible employees is the average of the actual deferral ratios of the eligible employees in that group. The ADP as well as the actual deferral ratios are calculated to the nearest hundredth of a percentage point. In general, an eligible employee's actual deferral ratio is the amount of the employee's elective contributions divided by the employee's compensation. Qualified matching contributions (QMACs) and qualified non-elective contributions (QNECs) that are treated as elective contributions for purposes of the ADP test are added to the employee's elective contributions. Reg. § 1.401(k)-1(g)(1)(ii)(A). Elective contributions treated as matching contributions for purposes of the ACP test are disregarded. Reg. § 1.401(k)-1(b)(4)(ii).
- k. The actual deferral ratio of a highly-compensated employee will be computed differently where the highly-compensated employee is eligible to participate in two or more 401(k) plans. In this case, the actual deferral ratio of the highly-compensated employee will be calculated by treating all of the 401(k) plans as one plan. Reg. § 1.401(k)-1(g)(1)(ii)(B).

3. Correction for a failed ADP test.

- a. If the ADP test for a plan year is not satisfied, the portion of the 401(k) plan attributable to the elective contribution and, possibly, the plan in its entirety will no longer be qualified. However, the regulations provide the following alternatives to correct the ADP test.
  - i. The employer makes additional QNECs or QMACs that are treated as elective contributions for purposes of the ADP test and that, when combined with the elective contributions, cause the ADP test to be satisfied;

- ii. Excess contributions are recharacterized as after-tax contributions; or
- iii. Excess contributions and allocable income are distributed.

Additionally, excess contributions may be recharacterized as "catch-up" contributions for HCEs who have attained age 50. This is the initial required method of correction for plans permitting catch-up contributions.

A plan may use any one or more of these correction methods. Reg. §§ 1.401(k)-1(f)(1)(ii), 1.401(k)-1(f)(1)(ii). It is impermissible for excess contributions to remain unallocated or to be placed in a suspense account for allocation in future plan years. Reg. § 1.401(k)-1(f)(1)(iii).

The excess contribution for a highly compensated employee is the amount by which the highly-compensated employee's elective contributions must be decreased so that the highly-compensated employee's actual deferral ratio will cause the ADP test to be satisfied. The highly compensated employee with the highest actual deferral ratio is reduced first. If, after reducing this highly-compensated employee's actual deferral ratio to the actual deferral ratio of the highly-compensated employee with the second highest actual deferral ratio, the ADP test is still not satisfied, then the actual deferral ratio of these two highly-compensated employees is reduced further. This process is repeated until the ADP test is satisfied. Reg. § 1.401(k)-1(f)(2). Effective for plan years commencing after December 31, 1996, the deferrals by the highly compensated employees who have deferred the greatest dollar amount will be decreased first. I.R.C. § 401(k)(8)(C).

Consider the following example.

<b>Employee</b>	<b>Compensation</b>	<b>Elective Contributions</b>	<b>Actual Deferral Ratios</b>
A	\$150,000	\$7,500	5.00%
B	130,000	6,500	5.00
C	80,000	8,000	10.00
D	70,000	7,000	10.00
E	40,000	2,000	5.00
F	35,000	3,500	10.00
G	30,000	3,000	10.00
H	30,000	3,000	10.00
I	25,000	1,250	5.00
J	25,000	0	0.00
K	25,000	0	0.00
L	20,000	0	0.00

Employees A-D are HCEs because they each had compensation in excess of \$105,000 in the prior year (even though C and D have compensation of \$80,000 and \$70,000 for the current year). Employees E-L are NHCEs. The ADP for the HCE group is 7.5%  $((5\% + 5\% + 10\% + 10\%)/4)$  and the ADP for the NHCE group is 5.0%  $((5\% + 10\% + 10\% + 10\% + 5\% + 0\% + 0\% + 0\%)/8)$ . The ADP test is not met. The Corporation will not contribute QMACs or QNECs to the plan.

The ADP for the HCE group must be reduced to seven percent. The total excess contributions for the HCEs is determined as follows.

- Step 1: The elective contributions of HCE C and D are reduced by \$800 and \$700 respectively in order to reduce the ADR of HCE C and D to 9% each. The ADP  $(5\% + 5\% + 9\% + 9\%)$  now equals 7%.
- Step 2: The total excess contributions for the HCEs that must be distributed equals \$1500, the total reductions in elective contributions under Step 1.
- Step 3: The Plan distributes \$500 to HCE C (the HCE with the highest dollar amount of elective contributions) to equal the next highest amount deferred. Because the total amount distributed (\$500) is less than the total excess contributions, this step must be repeated. The plan then distributes \$500 each to HCE A and C. The following are the resulting elective contributions of the HCEs.

<u>Employee</u>	<u>Elective Contributions</u>
A	\$7000
B	\$6500
C	\$7000
D	\$7000

I.R.C. § 401(k)(8)(B); Reg. § 1.401(k)-1(f)(2); IRS Notice 97-2.

Summary.

- i. Determine the amount of the reduction by reference to the HCEs with the highest deferral percentage.
    - ii. Make the actual reduction from the HCEs with the highest dollar deferrals.
  - b. Excess contributions that are recharacterized are includable in the employee's gross income on the earliest date that any elective contributions would have been received had the employee elected to receive the elective contributions in cash. Although includable in gross income, recharacterized excess contributions are generally treated as employer contributions. However, they will be treated as employee contributions for purposes of the ACP test. Reg. § 1.401(k)-1(f)(3)(ii). It should be noted that the *recharacterization of excess contributions as employee contributions will often result in a failure to satisfy the ACP test. Consequently, these recharacterized excess contributions will ultimately be distributed to correct the ACP test.*
  - c. The corrective distribution rule requires that excess contributions and income allocable to those contributions be distributed to the appropriate highly-compensated employees after the close of the plan year, but not later than twelve months thereafter. Reg. § 1.401(k)-1(f)(4). An employee or spousal consent is not required for a distribution of excess contributions. Reg. § 1.401(k)-1(f)(4)(iii). Amounts so distributed are not subject to the ten percent additional tax on premature distributions under I.R.C. § 72(t). If the excess contributions are distributed within 12 months after the end of the plan year but more than 2-1/2 months thereafter, the employer will be subject to a 10% excise tax on the amount of excess contributions. This excise tax can be avoided if the employer makes qualified matching contributions or a qualified non-elective contribution. Reg. § 1.401(k)-1(f)(6)(i); I.R.C. § 4979. Effective starting in 2008 Plan Year, the amount of any corrective distribution will be includable in the employee's income in the year distributed. If excess contributions and allocable income are not distributed within the twelve-month period following the plan year in which the excess contributions arose, the portion of the plan attributable to elective contributions will no longer be qualified for that plan year and all later plan years during which the excess contribution is not corrected. Elective contributions would be includable in an employee's gross income at the time the cash would have been received but for the employee's election. Reg. § 1.401(k)-1(f)(6)(ii).
4. Pension Protection Act of 2006 (PPA) Simplifies Administration of 401(k) Corrective Distributions.

- a. All ADP/ACP testing refunds will now be taxable in the year distributed. Under prior law, refunds within the 2-1/2 month window were taxable in the previous year.
  - b. "Gap period" earnings on refunds will not be required if paid under the 2-1/2 month rule for all 401(k) plans and the new six month rule for passively enrolled plans.
  - c. The new rules are generally effective for the 2008 plan year.
5. Distributions of excess deferrals, excess contributions and excess aggregate contributions are reported on IRS Form 1099-R for the year of the corrective distribution.
  6. Prior year versus current year testing.

Unless otherwise elected, ADP/ACP testing is performed using the prior year option. The election must be reflected in the plan document.

- a. Prior year testing.

Under prior year testing, the ADP (or ACP) of the HCEs in the current year is compared with the ADP (or ACP) of the NHCEs in the prior year.

In the first year of the plan, or in the case of a plan which is amended to allow salary deferrals or matching contributions, a deemed prior year ADP and ACP for the NHCEs of three percent can be used.

If the test is failed, corrections are made by returning contributions to the HCEs, providing a QNEC to some or all of the NHCEs or, in the case of the ADP test, recharacterizing salary deferrals as after-tax contributions.

If correction is to be made by providing QNECs and QMACs, these contributions are adjustments to the prior year ADP/ACP. This raises some issues which may make QNEC/QMAC corrections less appealing in prior year testing.

In order to adjust the prior year ADP/ACPs, the QNEC/QMACs must be made by the last day of the current plan year (*i.e.*, last day of the plan year following the year in which they are to be applied). In most cases, the final ADP/ACP test is not done until after the plan year is over and therefore it will be too late to make QNEC/QMAC contributions. In these cases, a preliminary ADP/ACP test may need to be performed before the end of the plan year and

estimated QNEC/QMACs based on this preliminary test deposited before the end of the year.

QNEC/QMACs based on preliminary ADP/ACP tests may not be possible for plans in which the plan document specifies that QNEC/QMAC contributions can only be made in amounts necessary to pass the ADP/ACP tests. If the ADP/ACP test is not completed by the end of the year, it will be too late for QNECs or QMACs to be contributed.

b. Current year testing.

Under current year testing, the ADP (or ACP) of the HCEs in the current year is compared with the ADP (or ACP) of the NHCEs in the current year.

If the test is failed, corrections are made by returning contributions to the HCEs, providing a QNEC to some or all of the NHCEs or, in the case of the ADP test, recharacterizing salary deferrals as after-tax contributions.

Since the QNEC/QMAC will apply in the current plan year, they need not be made until the last day of the next plan year (*i.e.*, last day of plan year following the plan year in which they are to be applied).

c. Switching between prior year and current year testing.

Notice 98-1.

Provides a wide array of guidance and transitional relief on the application of recent changes in the nondiscrimination rules under ADP and ACP tests. Key provisions focus on the use of the “prior year” method versus the “current year” method.

i. Background.

Prior to SBJPA, only the current year’s data on nonhighly compensated employees (NHCEs) could be used for nondiscrimination testing. SBJPA allows either the use of the prior year’s data for NHCEs or an election to use the current year’s data.

ii. Switching methods.

(a) Relatively easy *if* switch is from use of “prior year” method to use of “current year” method.

(i) No notification to IRS is required, but the switch must be in the plan document.

- (ii) No permissive aggregation of plans using different methods.
  - (iii) QNECs, QMACs must be made by the end of the testing year to be counted.
- (b) Fairly difficult if switch is from use of “current year” method to “prior year” method. SBJPA ’96 provided that such changes can be made “only as provided by the Secretary.”
- (i) General rule.  
 Okay if the old method was used consistently for five years. Rationale: prevent “cherry picking” of method based on best result each year.
  - (ii) Certain mergers and acquisitions during § 410(b) transition period also allow method switch.
  - (iii) Otherwise, Treasury officials indicate they will generally resist allowing method changes.
- iii. Effects of plan population changes. The “prior year” method can generally be used without regard to subsequent changes, except for changes in coverage (*i.e.*, eligibility); then a weighted average approach is to be used.

C. Actual Contribution Test (ACP).

1. The Average Contribution Percentage (ACP) Test under I.R.C. § 401(m) is virtually identical to the ADP test under § 401(k) except that the ACP test is used to test employee after-tax contributions and/or employer matching contributions.
2. All or any portion of the elective contributions and QNECs made with respect to employees who are eligible employees under the plan may be treated as matching contributions for purposes of the ACP test. If QNECs are treated as matching contributions, two requirements must be met. First, the allocation of non-elective contributions *including* the QNECs must be non-discriminatory. Second, the allocation of non-elective contributions, *excluding* the QNECs must be non-discriminatory. Reg. § 1.401(k)-1(b)(4)(ii).

3. If the ACP test for a plan year is not satisfied, the plan will no longer be qualified. However, the regulations provide the following devices for correcting an ACP test.
  - a. The employer makes QNECs that are treated as matching contributions for purposes of the ACP test and that, when combined with the employee matching contributions, cause the ACP test to be satisfied;
  - b. Elective contributions are treated as matching contribution for purposes of the ACP test and, when combined with employee matching contributions, cause the ACP test to be satisfied;
  - c. Excess aggregate contributions and allocable income are distributed; or
  - d. If the plan provides, excess aggregate contributions, to the extent attributable to non-vested matching contributions and allocable income, are forfeited.

The plan may use any one or more of these correction methods. Reg. §§ 1.401(m)-1(e)(1)(i), 1.401(m)-1(e)(1)(ii).

It is impermissible for excess aggregate contributions to remain unallocated or to be placed in a suspense account for allocation of future plan years. Also, excess aggregate contributions may not be corrected by forfeiting vested matching contributions, recharacterizing matching contributions or not making matching contributions required under the terms of the plan. Reg. § 1.401(m)-1(e)(1)(iii). Finally, any method of distributing excess aggregate contributions must be non-discriminatory. Reg. § 1.401(m)-1(e)(4).

If excess contributions are recharacterized or distributed, 401(k) plan must be sure that the level of matching contributions is non-discriminatory. For example, if a plan matches elective contributions on dollar-for-dollar basis, each dollar of elective contribution that is distributed or recharacterized must result in a forfeiture of a dollar of matching contribution. On the other hand, if the match is made only on elective contributions up to six percent of compensation, no matching contributions are required to be forfeited if a highly-compensated employee receives a distribution of excess contributions necessary to bring the highly-compensated employee's actual deferral ratio from eight percent to seven percent. Reg. § 1.401(m)-1(e)(4).

To the extent attributable to matching contributions, excess aggregate contributions, including forfeited matching contributions, are treated as employer contributions for purposes of I.R.C. § 404. A forfeited matching contribution is considered an annual addition under I.R.C. § 415 with respect to the highly-compensated employee whose excess aggregate contribution includes the forfeited matching contribution. Reg. § 1.401(m)-1(e)(3)(iv).

4. Distributions of excess deferrals, excess contributions and excess aggregate contributions are reported on IRS Form 1099-R for the year of the corrective distribution.
5. There is a safe harbor method of satisfying the special nondiscrimination test applicable to employer matching contributions (the ACP test).
  - a. The plan must meet the safe harbor contribution and notice requirements applicable to § 401(k) arrangements.
  - b. The plan must meet the following limitations on matching contributions.
    - i. Employer matching contributions may not be made with respect to employee contributions or elective deferrals in excess of six percent of compensation;
    - ii. The rate of an employer's matching contribution may not increase as the rate of an employee's contributions or elective deferrals increases; and
    - iii. The matching contribution with respect to any highly compensated employee at any rate of employee contribution or elective deferral is not greater than that with respect to an employee who is not highly compensated.
  - c. Any after-tax employee contributions continue to be tested separately under the ACP Test. I.R.C. § 401(m)(11).

D. Aggregation Rules.

1. Permissive aggregation.

Two or more plans of an employer may be considered as a single arrangement. I.R.C. § 401(k)(3)(A); Reg. § 1.401(k)-1(b)(3).

2. Required aggregation.

If a highly compensated employee participates in two or more plans of an employer, such plans are considered a single arrangement if each plan has a CODA. I.R.C. § 401(k)(3)(A); Reg. § 1.401(k)-1(g)(1)(ii)(B).

E. Inclusion for FICA.

1. Elective deferrals (Elective Employee Contributions) are included in a participant's compensation for purposes of FICA tax (I.R.C. § 3121(v)(1)) and FUTA tax. (I.R.C. § 3306(r)(1)(A)).

**VI. MISCELLANEOUS QUALIFICATION ISSUES**

A. Impact of Top-Heavy Rules.

1. Matching contributions are counted for top-heavy minimum contributions. Reg. § 1.416-1 Q&A M-19.
2. Elective contributions and matching contributions on behalf of key employees are taken into account in determining the minimum required top-heavy contribution. However, elective contributions on behalf of non-key employees may not be treated as employer contributions for purposes of satisfying the minimum contribution requirements. Reg. § 1.416-1, Q&A M-19, Q&A M-20.
3. The impact of the top-heavy rules upon a top-heavy § 401(k) plan may require that an employer contribute three percent of compensation (the top-heavy minimum contribution) to a § 401(k) plan on behalf of all non-key employees in order to permit key employees to make elective deferrals into the plan. If such a three percent of pay contribution qualifies as a Qualified Non-Elective Contribution, it may also be taken into account for the ADP test and thereby permit highly-compensated employees to defer an average of 5% (i.e., 3% + 2% under the alternative 200%/2% ADP test) of compensation into the plan.
4. Top heavy minimum contributions of 3% of compensation may be used to satisfy the ADP/ACP safe harbor rules. A 401(k) plan satisfying the safe harbor matching contributions also satisfies the top heavy minimum contributions.

B. Distributions Based on Hardship.

The regulations indicate that such

a distribution will be on account of hardship if the distribution is necessary in light of the immediate and heavy financial needs of the employee. The distribution cannot exceed the amount necessary to satisfy the hardship, the employee must not have other resources to satisfy the hardship, and the plan must set forth uniform and nondiscriminatory standards as to what constitutes a hardship.

PPA allows hardship distributions with respect to any designated beneficiary, not just a spouse or dependent.

Hardship withdrawals are only permitted to be made from the principal portion of employee elective deferrals (the “distributable amount”). If the plan so provides, however, the distributable amount may be increased by the earnings allocable to the elective deferrals. Reg. § 1.401(k)-1(d)(2). The total amount of a hardship distribution may be “grossed up” for payment of federal, state, local and excise taxes.

1. Six events are automatically deemed by the regulations to constitute an immediate and heavy financial need. These events include:
  - a. Unreimbursed medical expenses of the employee, the employee’s spouse, dependents, or beneficiaries (amounts for medical expenses may be obtained prior to actually incurring the expense if the plan sponsor develops specific procedures to permit such withdrawals);
  - b. Purchase of a principal residence for the employee;
  - c. Payment of tuition for the next twelve months of post-secondary education for an employee, his spouse, children, dependents, or beneficiaries;
  - d. Payments needed to prevent eviction of an employee from his principal residence or foreclosure on his mortgage on his principal residence;
  - e. Burial or funeral expenses; or
  - f. Expenses for the repair of damage to the principal residence due to fire, storm or other casualty.

Reg. § 1.401(k)-1(d)(2)(iii)(B).

2. An employer must determine that the distribution must be necessary to satisfy a financial need after all of the resources of the employee have been exhausted. The employer can satisfy this requirement by its reasonable reliance on the employee’s representation that the need cannot be relieved through:
  - a. Reimbursement or compensation by insurance or otherwise;
  - b. Reasonable liquidation of the employee’s assets to the extent that such liquidation will not cause an immediate and heavy financial need;
  - c. Cessation of elective contributions or employee contributions under the plan (12 month prohibition of elective contributions for plan years prior to 2002; 6 month prohibition for plan years commencing on or after January 1, 2002);

- d. Any other distributions or nontaxable loans from plans maintained by the employer or any other employer; or
- e. Borrowing from commercial sources on reasonable commercial terms.

Reg. § 1.401(k)-1(d)(2)(iii)(A).

- 3. Hardship distributions from § 401(k) and § 403(b) plans are not eligible rollover distributions. Therefore, such distributions cannot be rolled over to IRAs and are not subject to the twenty percent federal income tax withholding requirement. Effective for distributions after December 31, 1999. IRS Notice 99-5; IRS Notice 2000-32.

C. Trust Accounting Rules.

- 1. Department of Labor Regulations establish trust rules for employee contributions to plans. The D.O.L. Regulations were revised effective February 3, 1997.
- 2. The final regulations require that all employee contributions to a pension or welfare benefit plan must be transferred to a trust or an insurance company “as of the earliest date on which such contributions can reasonably be segregated from the employer’s general assets” but in no event later than the fifteenth business day of the month following the month in which the participant contributions are withheld or received by the employer. 29 C.F.R. § 2510.3-102(b).
  - a. The Department of Labor generally believes that the payroll pay date reflects the date when such contributions “can reasonably be segregated from the employer’s general assets” and, therefore, become plan assets.
  - b. Plans with fewer than 100 participants are deemed to comply with the plan-asset requirements when contributions are deposited with the plan no later than the seventh business day following the day on which such amount is received by the employer or the seventh business day following the day on which such amount would otherwise have been payable to the participant in cash.
- 3. Elective contributions to a CODA must be accounted for separately. Reg. § 1.401(k)-1(e)(3).

D. Definition of Compensation for I.R.C. § 415 Limitations.

- 1. For purposes of the I.R.C. § 415(c) limitations on contributions under a defined contribution plan (the lesser of \$40,000 [adjusted; \$49,000 for 2009] or 100% of compensation) the definition of compensation may include:

- a. Elective deferrals to § 401(k) plans or § 403(b) annuities;
- b. Elective contributions to a § 457 nonqualified deferred compensation plan; and
- c. Salary reduction contributions to a § 125 cafeteria plan. I.R.C. §§ 415(c)(3)(D) and 414(q)(4).

**VII. SIMPLE 401(k) PLAN (SAVINGS INCENTIVE MATCH PLAN FOR EMPLOYEES). I.R.C. § 401(k)(11)**

- A. An employer who does not employ over 100 employees earning at least \$5000 of compensation, or maintain another qualified plan may adopt a SIMPLE plan as part of a 401(k) arrangement. I.R.C. §§ 401(k)(11)(D)(i); 408(p)(1)(C)(i). The non-discrimination test applicable to elective deferrals and matching contributions will be satisfied if the plan meets the contribution and vesting requirements applicable to SIMPLE plans.
- B. Three Requirements for a SIMPLE 401(k) Plan. I.R.C. § 401(k)(11)(D).
  1. Contribution requirement;
  2. Exclusive plan requirement; and
  3. Vesting requirement.
- C. Non-Discrimination Rules Do Not Apply to SIMPLE Plans. The Non-Discrimination Rules Will Not Apply If:
  1. An employee's elective deferrals for the year, expressed as a percentage of compensation, do not exceed \$11,500 for 2009 (indexed for inflation in \$500 increments); § 401(k)(11)(E);
  2. The employer makes contributions matching the employee's elective deferrals up to three percent of the employee's compensation for the year or makes a non-elective contribution of two percent of compensation for each eligible employee who has earned at least \$5000 in compensation from the employer for the year; and
  3. No other contributions are made under the arrangement. I.R.C. § 401(k)(11)(B).
- D. Notice of Non-Elective Contribution Election.

Employers who decide to make the two percent non-elective contribution must notify the employees of the election. If an employer makes such an election for any year, the employer must notify employees of the election within a reasonable period of time before the sixtieth day before the beginning of such year.

E. Both Employee and Employer Contributions Are Fully Vested. The Contributions Must Be 100% Vested at All Times.

F. Contributions to Other Plans Prohibited.

A SIMPLE 401(k) plan will not satisfy the non-discrimination test if contributions are made to any other qualified plan of the employer.

G. Exception from Top-Heavy Plan Rules.

If the SIMPLE 401(k) plan requirements are satisfied, the SIMPLE 401(k) plan will not be subject to the top-heavy rules. I.R.C. § 401(k)(11)(D)(11).

H. SIMPLE 401(k) Plans are subject to all the other qualification requirements of a 401(k) plan, including the \$200,000 (adjusted; \$245,000 for 2009) compensation limit and the I.R.C. § 415 limits. Rev. Proc. 97-9. Note: SIMPLE IRA's are *not* subject to the § 415 limitation of twenty-five percent of compensation. Employer contributions to SIMPLE 401(k) plans are *not* subject to the fifteen percent deduction limits on contributions to profit-sharing or stock bonus plans. I.R.C. § 404(a)(3)(A).

I. If an employer maintained a qualified plan and SIMPLE plan in the same year due to an acquisition, disposition or similar transaction, the SIMPLE plan's salary reduction arrangement may be treated as qualified for the year of the transaction and the following calendar year. I.R.C. § 408(p)(2)(D)(iii).

J. The Participant Election Requirements That Apply to SIMPLE IRA Plans Also Apply to SIMPLE 401(k)s. Thus, Under a SIMPLE 401(k) Plan:

1. An employee may elect to terminate participation in a salary reduction election at any time during the year. The plan may provide that an employee who terminates may not elect to resume participation until the next year; and
2. Each employee eligible to participate may elect, during the sixty-day period before the beginning of any year, to reduce salary and to have the elective amounts contributed to the plan, or to modify the amounts subject to the election, for that year. For employees who first become eligible, the election period is the sixty-day period before eligibility. I.R.C. § 401(k)(11)(B)(iii)(I).

The employer must notify each employee eligible to participate, within a reasonable period of time before the sixtieth day before the beginning of the year, of the rules for electing to participate (under the rules described above). An employee first becoming eligible must be notified within a reasonable period of time before the sixtieth day before the first day the employee is eligible. I.R.C. § 408(k)(11)(B)(iii)(II).