

# Section 401.—Qualified Pension, Profit-Sharing, and Stock Bonus Plans

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

T.D. 9169

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1 and 601

### Retirement Plans; Cash or Deferred Arrangements Under Section 401(k) and Matching Contributions or Employee Contributions Under Section 401(m) Regulations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance for certain retirement plans containing cash or deferred arrangements under section 401(k) and providing for matching contributions or employee contributions under section 401(m). These regulations affect sponsors of plans that contain cash or deferred arrangements or provide for employee or matching contributions, and participants in these plans.

EFFECTIVE DATE: December 29, 2004.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, R. Lisa Mojiri-Azad or John T. Ricotta at (202) 622-6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995

(44 U.S.C. 3507(d)) under control number 1545-1669. Responses to this collection of information are mandatory.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

The estimated annual burden per respondent varies from .033 hour to 2.5 hours, depending on the individual circumstances, with an estimated average of 1 hour, 10 minutes.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

#### Background

This document contains final regulations setting forth the requirements (including the nondiscrimination requirements) for cash or deferred arrangements under section 401(k) and for matching contributions and employee contributions under section 401(m) of the Internal Revenue Code (Code).

Comprehensive final regulations under sections 401(k) and 401(m) of the Code were last published in the **Federal Register** in T.D. 8357, 1991-2 C.B. 181, (published August 9, 1991) and T.D. 8376, 1991-2 C.B. 245, (published December 2, 1991) and amended by T.D. 8581, 1995-1 C.B. 54, published on December 22, 1994 (the pre-SBJPA regulations). Since 1994, many significant changes have been made to sections 401(k) and 401(m) by the Small Business Job Protection Act of 1996,

Public Law 104-188 (110 Stat. 1755) (SBJPA), the Taxpayer Relief Act of 1997, Public Law 105-34 (111 Stat. 788) (TRA '97), and the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107-16 (115 Stat. 38) (EGTRRA).

The most substantial changes to the statutory provisions of section 401(k) and section 401(m) were made to the methodology for testing the amount of elective contributions, matching contributions, and employee contributions for nondiscrimination. Section 401(a)(4) prohibits discrimination in contributions or benefits in favor of highly compensated employees, within the meaning of section 414(q) (HCEs). Section 401(k) provides a special nondiscrimination test for elective contributions under a cash or deferred arrangement that is part of a profit-sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan, called the actual deferral percentage (ADP) test. Section 401(m) provides a parallel test for matching contributions and employee contributions under a defined contribution plan, called the actual contribution percentage (ACP) test. These special nondiscrimination standards are provided in recognition of the fact that the amount of elective contributions and employee contributions (and corresponding matching contributions) is determined by the employee's utilization of the contribution opportunity offered under the plan. This is in contrast to the situation in other defined contribution plans where the amount of contributions is determined by the amount the employer decides to contribute.

Sections 401(k) and 401(m) provide alternative methods for satisfying the applicable nondiscrimination rules: a mathematical comparison and a number of design-based methods. The inherent variation in the amount of contributions among employees, and the fact that the economic situation of HCEs may make them more likely to make elective or employee contributions, means that the usual nondiscrimination test under section 401(a)(4) — under which, for each HCE with a contribution level, there must be a specified number of nonhighly compensated employees

(NHCEs) with equal or greater contributions — is not appropriate. Instead, average rates of contributions are used in the ADP and ACP tests (with a built-in differential permitted for HCEs) and minimum standards for nonelective or matching contributions are provided in the design-based alternatives.

Prior to the enactment of SBJPA, sections 401(k) and 401(m) provided only for mathematical comparison. Specifically, the ADP and ACP tests compare the average of the rates of contributions of the HCEs to the average of the rates of contributions of the NHCEs. For this purpose, the rate of contributions for an employee is the amount of contributions for an employee divided by the employee's compensation for the plan year. These tests are satisfied if the average rate of HCE contributions does not exceed 1.25 times the average rate of contributions of the NHCEs. Alternatively, these tests are satisfied if the average rate of HCE contributions does not exceed the average rate of contributions of the NHCEs by more than 2 percentage points and is no more than 2 times the average rate of contributions of the NHCEs. To the extent that these tests are not satisfied, the statute provides for correction through distribution to HCEs (or forfeiture of non-vested matching contributions) or, to the extent provided in regulations, recharacterization of elective contributions as after-tax contributions. In addition, to the extent provided in regulations, nonelective contributions can be made to NHCEs and elective contributions and certain matching contributions can be moved between the ADP and ACP tests, in order to reduce the discrepancy between the average rates of contribution for the HCEs and the NHCEs.

SBJPA added design-based alternative methods of satisfying the ADP and ACP tests. Under these methods, if a plan meets certain contribution and notice requirements, the plan is deemed to satisfy the nondiscrimination rules without regard to actual utilization of the contribution opportunity offered under the plan. These regulations reflect this change and the other changes that were made to sections 401(k) and 401(m) under SBJPA, TRA '97 and EGTRRA since the issuance of the pre-SBJPA regulations.

SBJPA made the following significant changes affecting section 401(k) and section 401(m) plans:

- The ADP test and ACP test were amended to allow the use of prior year data for NHCEs.
- The method of distributing to correct failures of the ADP test or ACP test was changed to require distribution to the HCEs with the highest contributions.
- Tax-exempt organizations and Indian tribal governments are permitted to maintain section 401(k) plans.
- Safe harbor alternatives to the ADP test and ACP test were introduced in order to provide design-based methods to satisfy the nondiscrimination tests.
- The SIMPLE 401(k) plan (an alternative design-based method to satisfy the nondiscrimination tests for small employers that corresponds to the provisions of section 408(p) for SIMPLE IRA plans by providing for smaller contributions) was added.
- A special testing option was provided for plans that permit participation before employees meet the minimum age and service requirements, in order to encourage employers to permit employees to start participating sooner.

TRA '97 made the following significant changes affecting section 401(k) and section 401(m) plans:

- Grandfathered state and local governmental plans are treated as automatically satisfying the ADP and ACP tests.
- Matching contributions for self-employed individuals are no longer treated as elective contributions.

EGTRRA made the following significant changes affecting section 401(k) and section 401(m) plans:

- Catch-up contributions were added to provide for additional elective contributions for participants age 50 or older.
- The Secretary is directed to change the section 401(k) regulations to shorten the period of time that an employee is stopped from making elective contributions under the safe harbor rules for hardship distributions.

- Beginning in 2006, section 401(k) plans will be permitted to allow employees to designate their elective contributions as "Roth contributions" that will generally be subject to taxation under the rules applicable to Roth IRAs under section 408A.
- Section 401(k) plans using the design-based safe harbor and providing no additional contributions in a year are exempted from the top-heavy rules of section 416.
- Distributions from section 401(k) plans are permitted upon "severance from employment" rather than "separation from service."
- The multiple use test formerly specified in section 401(m)(9) is repealed.
- Faster vesting is required for matching contributions.
- Matching contributions are taken into account in satisfying the top-heavy requirements of section 416.

In addition, since publication of the pre-SBJPA regulations, a number of items of guidance affecting section 401(k) and section 401(m) plans addressing these statutory changes and other issues have been released by the IRS, including:

- Notice 97-2, 1997-1 C.B. 348, provides initial guidance on prior year ADP and ACP testing and guidance on correction of excess contributions and excess aggregate contributions, including distribution to the HCEs with the highest contributions.
- Rev. Proc. 97-9, 1997-1 C.B. 624, provides model amendments for SIMPLE 401(k) plans.
- Notice 98-1, 1998-1 C.B. 327, provides additional guidance on prior year testing issues.
- Notice 98-52, 1998-2 C.B. 632, and Notice 2000-3, 2000-1 C.B. 413, provides guidance on safe harbor section 401(k) plans.
- Rev. Rul. 2000-8, 2000-1 C.B. 617, addresses the use of automatic enrollment features in section 401(k) plans.
- Notice 2001-56, 2001-2 C.B. 277, and Notice 2002-4, 2002-1 C.B. 298, provided initial guidance related to the changes made by EGTRRA.

These items of guidance, with some modification, were incorporated into the

proposed regulations (REG-108639-99, 2003-2 C.B. 431) under section 401(k) and section 401(m) which were published in the **Federal Register** on July 17, 2003. 68 Fed. Reg. 42,476.

On November 12, 2003, a public hearing was held on the proposed regulations. After consideration of the comments, these final regulations adopt the provisions of the proposed regulations with certain modifications, the most significant of which are highlighted below.

## Explanation of Provisions

### 1. Rules Applicable to All Cash or Deferred Arrangements

Section 401(k)(1) provides that a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan will not fail to qualify under section 401(a) merely because it contains a qualified cash or deferred arrangement. As under the proposed regulations, §1.401(k)-1 sets forth the general definition of a cash or deferred arrangement (CODA), the additional requirements that a CODA must satisfy in order to be a qualified CODA, and the treatment of contributions made under a qualified or nonqualified CODA.

As under the proposed regulations, the final regulations define a CODA as an arrangement under which employees can make a cash or deferred election with respect to contributions to, or accruals or benefits under, a plan intended to satisfy the requirements of section 401(a). A cash or deferred election is any direct or indirect election by an employee (or modification of an earlier election) to have the employer either: 1) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available; or 2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. These final regulations retain the definition of a CODA from the proposed regulations, with some minor modifications. First, the exclusion of an arrangement under which employees make after-tax contributions from the definition of a

CODA does not encompass an arrangement under which employees make designated Roth contributions.<sup>1</sup> Second, the final regulations clarify that the regulatory provision specifying that compliance with section 401(k) and section 402(e)(3) is the only means of providing a cash or deferred election to an employee without violating the constructive receipt rules is limited to cash or deferred elections under which the contribution or accrual is made under a qualified plan or trust.

As under the proposed regulations, these final regulations incorporate prior guidance on automatic enrollment and thus reflect the fact that a CODA can specify that the default that applies in the absence of an affirmative election by an employee can be a contribution to a trust, as described in Rev. Rul. 2000-8. Although the facts of Rev. Rul. 2000-8 specified a certain percentage of compensation that would apply as a default, the percentage chosen was merely illustrative. Thus, the final regulations do not constrain the choice of default provisions.<sup>2</sup> However, in order to be a qualified CODA, as indicated in Rev. Rul. 2000-8, it is essential that the employee have an effective opportunity to elect to receive cash in lieu of the default employer contribution.

These final regulations also clarify the rules relating to one-time irrevocable elections that are not treated as cash or deferred elections. First, the final regulations replace the requirement that the election be made upon commencement of employment or first becoming eligible under the plan or any plan of the employer with the requirement that the election be made no later than first becoming eligible under the plan or any other plan of the employer. Second, the final regulations define any other plan of the employer for this purpose to mean any plan or arrangement that is described in section 219(g)(5)(D), which includes a section 457(b) governmental plan and a section 403(b) plan, as well as a qualified plan.

The final regulations retain the rule that a contribution is made pursuant to a cash or deferred election only if the contribu-

tion is made after the relevant election. Thus, a contribution made in anticipation of an employee's election is not treated as an elective contribution. A number of commentators indicated that the rule in the proposed regulation requiring that elective contributions not precede the services to which they relate (or the date when the compensation would otherwise be paid, if earlier than the date when the services are performed) was too broad. Some of these commentators suggested the addition of an exception to cover instances where the employer has administrative reasons for depositing the contributions before the employee's services or pay day (for example, the temporary absence of the bookkeeper responsible for transmitting funds to the plan), while others suggested loosening the rule where the early contribution does not result in an accelerated deduction.

After considering these comments, the IRS and Treasury have concluded that the prefunding of elective contributions and matching contributions is inconsistent with sections 401(k) and 401(m) and that the restrictions on the timing of contributions are consistent with the fundamental premise of elective contributions (*i.e.*, these are contributions that are paid to the plan as a result of an employee election not to receive those amounts in cash). Accordingly, the final regulations generally provide that contributions are made pursuant to a cash or deferred election only if the contributions are made after the employee's performance of services which relate to the compensation that, but for the election, would have been paid to the employee. Amounts contributed in anticipation of future performance of services generally are not treated as elective contributions under these final regulations. Thus, an employer is not able to prefund elective contributions in order to accelerate the deductions for elective contributions; and employer contributions made under the facts in Notice 2002-48, 2002-2 C.B. 130, are no longer permitted to be taken into account under the ADP test or the ACP test and would not satisfy

<sup>1</sup> A designated Roth contribution is an elective contribution that is included in income. The Treasury and the IRS expect to issue guidance on designated Roth contributions in the near future.

<sup>2</sup> The Department of Labor has advised Treasury and the IRS that, under Title I of the Employee Retirement Income Security Act of 1974 ("ERISA") (88 Stat. 829), Public Law 93-406, fiduciaries of a plan must ensure that the plan is administered prudently and solely in the interest of plan participants and beneficiaries. While ERISA section 404(c) may serve to relieve certain fiduciaries from liability when participants or beneficiaries exercise control over the assets in their individual accounts, the Department of Labor has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. See 29 CFR 2550.404c-1 and 57 FR 46924.

any plan requirement to provide elective contributions or matching contributions.

The proposed regulations contained an exception to the rule precluding the funding of elective contributions before the performance of services in the situation where the compensation would also have been paid, but for the election, before the performance of services and that exception has been retained in the final regulations. After consideration of the administrative concerns raised by the comments, these final regulations also include an exception for occasional *bona fide* administrative considerations. Under this exception, employer contributions will not fail to satisfy the regulatory requirements relating to the timing of elective contributions merely because contributions for an occasional pay period are made before the services with respect to that pay period are performed, provided that the early contributions are made for *bona fide* administrative considerations and are not made early with a principal purpose of accelerating deductions. In addition, the final regulations include changes to the rules precluding the prefunding of matching contributions discussed below.

One commentator asked for clarification of the interaction between these timing rules and the rule under the regulations that treats a self-employed individual's earned income as being currently available on the last day of the individual's taxable year and whether this last day rule precludes a partner from making elective contributions during the year through a reduction in the partner's draw. The restriction on the timing of contributions is not intended to prevent a partner from deferring amounts that are paid to the partner throughout the year on account of services performed by the partner during the year, and the final regulations have been modified to clarify this point. However, self-employed individuals who take advantage of this opportunity to defer amounts during the year must make sure that the amount contributed during the year will not exceed the limits (such as the limits of section 415) that will apply to the individual, based on the individual's actual earned income for the relevant period.

## 2. Qualified CODAs

### A. General rules relating to qualified CODAs

Elective contributions under a qualified CODA are treated as employer contributions for purposes of the Internal Revenue Code.<sup>3</sup> Elective contributions under a qualified CODA generally are not included in the employee's gross income at the time the cash would have been received (but for the cash or deferred election) or at the time contributed to the plan. Elective contributions under a qualified CODA are included in the employee's gross income, however, if the contributions are in excess of the section 402(g) limit for a year, are designated Roth contributions (under section 402A, effective for tax years beginning after December 31, 2005), or are recharacterized as after-tax contributions as part of a correction of an ADP test failure.

A CODA is not qualified unless it is part of a profit sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan and provides for an election between contributions to the plan or payments directly in cash. In addition, a CODA is not qualified unless it meets the following requirements: 1) the elective contributions under the CODA satisfy either the ADP test set forth in section 401(k)(3) or one of the design-based alternatives in section 401(k)(11) or (12); 2) elective contributions under the CODA are nonforfeitable at all times; 3) elective contributions are distributable only on the occurrence of certain events, including attainment of age 59½, hardship, death, disability, severance from employment, or termination of the plan; 4) the group of employees eligible to participate in the CODA satisfies the coverage requirements of section 410(b)(1); 5) no other benefit (other than matching contributions and certain other specified benefits) is conditioned, directly or indirectly, upon the employee's making or not making elective contributions under the CODA; and 6) no more than 1 year of service is required for eligibility to elect to make a cash or deferred election.

Subject to certain exceptions, State and local governmental plans are not allowed

to include a qualified CODA. Plans sponsored by Indian tribal governments and rural cooperatives are allowed to include a qualified CODA.

### B. Nondiscrimination rules applicable to qualified CODAs

As under the proposed regulations, these final regulations provide that the special nondiscrimination standards set forth in section 401(k) (the ADP test, the ADP safe harbor and the SIMPLE 401(k) plan) are the exclusive means by which a qualified CODA can satisfy the nondiscriminatory amount of contribution requirement of section 401(a)(4). Pursuant to section 401(k)(3)(G), a State or local governmental plan is deemed to satisfy the ADP test.

These final regulations retain the rule that the plan must satisfy the requirements of §1.401(a)(4)-4 with respect to benefits, rights and features in addition to the requirements that contributions satisfy the nondiscrimination requirements of section 401(k). In addition to stating that the availability of each level of elective contribution is a right or feature subject to the requirements of section 401(a)(4), the final regulations point out that the right to make a designated Roth contribution is a right or feature.

The proposed regulations included an anti-abuse rule which provided that a plan will not be treated as satisfying the requirements of section 401(k) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted deferrals for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(k), if a principal purpose of the changes was to achieve such a result.

Several commentators suggested eliminating the anti-abuse rule in the proposed regulations. One of these commentators suggested that the proposed regulation's restrictions on ADP testing (including the restriction on the use of targeted QNECs and changes in testing method discussed below) made the anti-abuse rule unnecessary and noted that there may be legitimate reasons (for example, change in participant demographics or merger of plans

<sup>3</sup> The Department of Labor has advised Treasury and the IRS that its view is that amounts a participant pays to or has withheld by an employer, whether pursuant to a cash or deferred election or otherwise, for contribution to an employee benefit plan constitute participant contributions for purposes of Subtitle A and Part 4 of Subtitle B of Title I of ERISA.

for administrative reasons) for changes to a section 401(k) plan's testing procedures. Another commentator suggested that the anti-abuse rule be replaced with guidance addressing various specific abusive transactions.

After considering these comments, IRS and Treasury have determined that the need for rules to prevent abuse associated with changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs or to otherwise manipulate the nondiscrimination provisions of section 401(k) outweighs the concerns raised by these commentators. In addition, IRS and Treasury do not believe that the anti-abuse provisions of the proposed regulations constrain legitimate testing procedure changes. Therefore, these final regulations retain the anti-abuse provisions of the proposed regulations.

### *C. Aggregation and disaggregation of plans*

As under the proposed regulations, these final regulations consolidate the rules regarding identification of CODAs and plans for purposes of demonstrating compliance with the requirements of section 401(k) and retain the rule that all CODAs included in a plan are treated as a single CODA for purposes of applying the nondiscrimination tests. For this purpose, a plan is generally defined by reference to §1.410(b)-7(a) and (b) after application of the mandatory disaggregation rules of §1.410(b)-7(c) (other than the mandatory disaggregation of section 401(k) and section 401(m) plans) and permissive aggregation rules of §1.410(b)-7(d), as modified under these regulations. For example, if a plan covers collectively bargained employees and noncollectively bargained employees, the elective contributions for the separate groups of employees must be treated separately for nondiscrimination under section 401(k). As under the proposed regulations, the final regulations retain the special rules in the pre-SBJPA regulations that permit the aggregation of certain employees in different collective bargaining units and the prohibition on restructuring under §1.401(a)(4)-9(c).

The proposed regulations included a change to the treatment of a CODA under a plan that includes an ESOP. Under the pre-SBJPA regulations, such a plan

must be disaggregated into the ESOP and non-ESOP portions and apply two separate ADP and ACP tests: one for elective contributions going into the ESOP portion (and invested in employer stock) and one for elective contributions going in the non-ESOP portion of the plan. The proposed regulations eliminated the disaggregation of the ESOP and non-ESOP portions of a single section 414(l) plan for purposes of ADP and ACP testing and allowed an employer to permissively aggregate two section 414(l) plans, one that is an ESOP and one that is not.

Commentators responded favorably to this change. Therefore, the final regulations retain the rule of the proposed regulations that eliminates the disaggregation of the ESOP and non-ESOP portions for the ADP and ACP tests. Several of these commentators suggested that plans be permitted to implement this change before the effective date of the regulations. After considering these comments, the IRS and Treasury have determined that it would not be in the best interest of plan administration to allow this change to be made before the effective date of the entire regulations. However, as discussed below, a plan is permitted to implement this change for plan years that end after December 29, 2004, provided the plan applies all the rules of these final regulations, to the extent applicable, for that plan year and all subsequent plan years.

These final regulations retain the proposed regulations' requirement that a single testing method must apply to all CODAs under a plan (after application of the aggregation and disaggregation rules as modified). This has the effect of restricting an employer's ability to aggregate section 414(l) plans for purposes of section 410(b) if those plans apply inconsistent testing methods. For example, a plan that applies the ADP test of section 401(k)(3) may not be aggregated with a plan that uses the ADP safe harbor of section 401(k)(12) for purposes of section 410(b). However, the final regulations make clear that if a plan is disaggregated into separate plans under the rules of section 410(b), each separate plan can apply a different testing method. Thus, for example, if an employer maintaining a plan that covers otherwise excludible employees is using the optional rule of section 410(b)(4)(B) to determine whether the

plan satisfies the requirements of section 410(b), then the plan is treated as comprising two separate plans for purposes of section 410(b) and the plan covering the employees who have satisfied the minimum age and service requirements of section 410(a)(1)(A) can use the ADP safe harbor of section 401(k)(12), while the plan covering the remaining employees uses the ADP test of section 401(k)(3).

### *D. Requirement that the elective contributions be immediately nonforfeitable*

The final regulations reflect the statutory requirement that elective contributions to a qualified CODA be immediately nonforfeitable. However, the final regulations clarify that the reference to these contributions being "disregarded for purposes of applying section 411(a) to other contributions" is limited to being disregarded for purposes of section 411(a)(2). Thus, for example, elective contributions under a qualified CODA are taken into account for purposes of determining whether a participant is a nonvested participant for purposes of section 411(a)(6)(D)(iii).

### *E. Restrictions on withdrawals*

As discussed above, a qualified CODA must provide that elective contributions may only be distributed after certain events, including hardship and severance from employment. EGTRRA amended section 401(k)(2)(B)(i)(I) by replacing "separation from service" with "severance from employment." This change eliminated the "same desk rule" as a standard for distributions under section 401(k) plans.

In addition, EGTRRA amended section 401(k)(10) by deleting disposition by a corporation of substantially all of the assets of a trade or business and disposition of a corporation's interest in a subsidiary, leaving termination of the plan as the only distributable event described in section 401(k)(10). Further, EGTRRA directs the Secretary of the Treasury to revise the regulations relating to distributions under section 401(k)(2)(B)(i)(IV) to provide that the period during which an employee is prohibited from making elective and employee contributions following a hardship distribution is 6 months

(instead of 12 months as required under §1.401(k)-1(d)(2)(iv)(B)(4) of the pre-SBJPA regulations).<sup>4</sup> Finally, section 662 of EGTRRA amended section 404(k)(2) to allow a deduction for dividends paid on employer securities held by an ESOP if those dividends are reinvested in employer securities pursuant to an election by the participant or beneficiary to reinvest the dividends or have them paid in cash. Section 662 of EGTRRA is effective for taxable years of a corporation beginning on or after January 1, 2002.

Notice 2001-56, Notice 2002-2, 2002-1 C.B. 285, and Notice 2002-4 provided guidance on these EGTRRA changes to the distribution rules for elective contributions. That guidance was generally incorporated in the proposed regulations. These final regulations adopt the rules in the proposed regulations but clarify that the requirement that a participant must have obtained all distributions currently available under all qualified plans of the employer in order to qualify for a hardship distribution applies equally to a distribution of an ESOP dividend. This implements the rule set forth in Notice 2002-2.

Comments were requested on whether a change in status from a common law employee to a leased employee described in section 414(n) should be treated as a severance from employment that would permit a distribution to be made. After reviewing the comments, these final regulations do not add the change to leased employee to the list of distributable events and retain the use of the section 410(b) definition of employee for purposes of section 401(k). Because an individual who is a leased employee (as defined in section 414(n)) is treated as an employee of the recipient of the individual's services for purposes of section 410(b) (unless the safe harbor plan requirements described in section 414(n)(5) are met), the individual does not incur a severance from employment as a result of becoming a leased employee.

In addition to the statutory changes, the rules relating to hardship distributions were reorganized in the proposed regulations in order to clarify certain ambiguities, including the relationship between

the generally applicable rules, employee representations, and the safe harbors provided under the pre-SBJPA regulations. The final regulations adopt the rules in the proposed regulations with some minor modifications. In response to comments, the final regulations add funeral expenses and certain expenses relating to the repair of damage to the employee's principal residence to the list of events that are deemed to be immediate and heavy financial needs.

The pre-SBJPA regulations and the proposed regulations treated medical expenses for an employee's spouse or dependent described in section 152 as a deemed heavy and financial need. The Working Families Tax Relief Act of 2004 (118 Stat. 1166), Public Law 108-311, modified section 152's definition of dependent, effective for tax years beginning in 2005. These final regulations revise the proposed regulations to disregard certain provisions in section 152's definition of dependent in the case of post-secondary educational expenses. These final regulations also revise the proposed regulations to treat expenses for (or necessary to obtain) medical care that would be deductible under section 213(d) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income) as a deemed heavy and financial need. These changes have the effect of allowing medical expenses and post-secondary educational expenses for an employee, spouse, or dependent (without regard to the change in the definition of dependent under the Working Families Tax Relief Act of 2004) to be treated as a deemed heavy and financial need. The modifications in these final regulations also effectively expand the definition of dependent for medical expenses to include a non-custodial child who is subject to the special rule of section 152(e), but would exclude nonprescription drugs or medicine (other than insulin). Prior to the effective date of these regulations with respect to a plan, a sponsor can continue to interpret the plan terms and the pre-SBJPA regulations without regard to the statutory change in the definition of dependent.

Some commentators asked for specific guidance on the documentation and verification requirements for a hardship distribution. The final regulations do not ad-

dress this issue. However, taxpayers are reminded that section 6001 requires that they keep the records necessary to demonstrate compliance with the qualification requirements of section 401 and the rules of section 401(k) and 401(m).

#### F. Other rules for qualified CODAs

The final regulations retain the additional requirements set forth in the pre-SBJPA regulations that a CODA must satisfy in order to be qualified, with some minor modifications. First, in order to be a qualified CODA, the arrangement must provide an employee with an effective opportunity to elect to receive the amount in cash no less than once during the plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including adequacy of notice of the availability of the election, the period of time before the cash is currently available during which an election may be made, and any other conditions on elections.

The final regulations also require a plan to provide for satisfaction of one of the specific nondiscrimination alternatives described in section 401(k). As with the pre-SBJPA regulations, the plan may accomplish this by incorporating by reference the ADP test of section 401(k)(3) and the regulations under proposed §1.401(k)-2(a) and (b), if that is the nondiscrimination alternative being used. If, with respect to the nondiscrimination alternative being used, there are optional choices available, the plan must provide which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3) must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the actual ADP for the eligible NHCEs for the first plan year. The final regulations also provide that the Commissioner may, in guidance of general applicability, specify the default options that will apply under the plan if the nondiscrimination test is incorporated by reference in accordance with the final regulations.

<sup>4</sup> Under section 402(c), as amended by the IRS Restructuring and Reform Act of 1998, Public Law 105-206 (112 Stat. 685), and EGTRRA, a hardship distribution is not an eligible rollover distribution. While the change affects distributions from a section 401(k) plan, there is no specific reference to the change in these regulations because these regulations are under sections 401(k) and (m).

Additionally, a plan that uses the safe harbor method must specify whether the safe harbor contribution will be the non-elective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. The safe harbors are intended to provide employees with a minimum threshold in benefits in exchange for easier compliance for the plan sponsor. It would be inconsistent with this approach to providing benefits to allow an employer to deliver smaller benefits to NHCEs and revert to testing. Accordingly, if, at the beginning of the plan year, a plan contains an allocation formula that includes safe harbor matching or nonelective contributions, these regulations clarify that, except to the extent permitted under §1.401(k)-3 and §1.401(m)-3, the plan may not be amended to revert to testing for the plan year.

The final regulations retain the existing rules relating to the section 401(k)(4)(A) prohibition on having benefits (other than a match) contingent on making or not making an elective contribution. These final regulations also reflect the amendment to section 416(c)(2)(A) (under which matching contributions can be taken into account for purposes of satisfying the top-heavy minimum contribution requirement without violating the prohibition on making benefits contingent on making or not making elective contributions), the amendment of section 401(k)(4)(B) by SBJPA (allowing tax exempt organizations to maintain section 401(k) plans), and the enactment of section 402(g)(8) (providing that matching contributions with respect to partners and sole proprietors are no longer treated as elective contributions).

### 3. *The Actual Deferral Percentage (ADP) Test*

#### A. *General rules relating to the ADP test*

Section 1.401(k)-2 sets forth the rules for a CODA that is applying the ADP test contained in section 401(k)(3). Under the ADP test, the percentage of compensation deferred for the eligible HCEs is compared annually to the percentage of compensation deferred for eligible NHCEs, and if certain limits are exceeded by the HCEs, corrective action must be taken by the plan.

Correction can be made through the distribution of excess contributions, the recharacterization of excess contributions, or additional employer contributions.

Section 401(k)(3)(A), as amended by SBJPA, generally provides for the use of prior year data in determining the ADP of NHCEs, while current year data is used for HCEs. This testing option is referred to as the prior year testing method. Alternatively, a plan may provide for the use of current year data for determining the ADPs for both NHCEs and HCEs, which is known as the current year testing method. The regulations use the term applicable year to describe the year for which the ADP is determined for the NHCEs.

Section 401(k)(3)(F), as added by SBJPA, provides that a plan benefiting otherwise excludable employees and that, pursuant to section 410(b)(4)(B), is being treated as two separate plans for purposes of section 410(b), is permitted to disregard NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). Thus, the regulations permit such a plan to perform the ADP test by comparing the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). Because section 401(k)(3)(F) is permissive, the final regulations follow the proposed regulations and do not eliminate the existing testing option under which a plan benefiting otherwise excludable employees is disaggregated into separate plans where the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements.

#### B. *Elective contributions used in the ADP test*

The regulations generally follow the proposed regulations in defining which elective contributions are reflected in the ADP test and which ones are not. Thus, these regulations reflect the rule contained in the regulations under section 414(v), under which catch-up contributions that are in excess of a statutory limit or an employer-provided limit are not taken

into account under the ADP test. See §1.414(v)-1. The final regulations add a comparable rule for additional elective contributions that are made by reason of an eligible employee's qualified military service pursuant to section 414(u). The final regulations retain the rule that elective contributions must be paid to the trust within 12 months after the end of the plan year. However, for plans subject to Title I of ERISA, contributions must be paid to the trust much sooner in order to satisfy the Department of Labor's regulations relating to when elective contributions become plan assets.

Section 401(k)(3) provides that the actual deferral ratio (ADR) of an HCE who is eligible to participate in 2 or more CODAs of the same employer is calculated by treating all CODAs in which the employee is eligible to participate as one CODA. These final regulations adopt the provision in the proposed regulations that provides that the ADR for each HCE participating in more than one CODA is determined by aggregating the HCE's elective contributions that are within the plan year of the CODA being tested.

#### C. *Additional employer contributions used in the ADP test*

The final regulations generally retain the rules in the proposed regulations permitting a plan to take qualified nonelective contributions or qualified matching contributions (*i.e.*, nonelective or matching contributions that satisfy the vesting and distribution limitations of section 401(k)(2)(B) and (C)) into account under the ADP test, except as described below. Thus, an employer whose CODA has failed the ADP test can correct this failure by making additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for its NHCEs.

As under the pre-SBJPA regulations, these final regulations provide that QNECs must satisfy four requirements in addition to the vesting and distribution rules described above before they can be taken into account under the ADP test: 1) The amount of nonelective contributions, including the QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 2) the amount of nonelective contributions, excluding the

QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 3) the plan to which the QNEC or QMAC is made must be a plan that can be aggregated with the plan maintaining the CODA; and 4) the QNECs or QMACs must not be contingent on the performance of services after the allocation date and must be contributed within 12 months after the end of the plan year within which the contribution is to be allocated.<sup>5</sup> Thus, in the case of a plan using prior year ADP testing, any QNECs that are to be allocated to the NHCEs for the prior plan year must be contributed before the last day of the current plan year in order to be taken into account.

Some plans provide a correction mechanism for a failed ADP test that targets QNECs to certain NHCEs in order to reduce the total contributions to NHCEs under the correction. Under the method that minimizes the total QNECs allocated to NHCEs under the correction, the employer makes a QNEC to the extent permitted by the section 415 limits to the NHCE with the lowest compensation during the year in order to raise that NHCE's ADR. If the plan still fails to pass the ADP test, the employer continues expanding the group of NHCEs who receive QNECs to the next lowest-paid NHCE until the ADP test is satisfied. By using this bottom-up leveling technique, the employer can pass the ADP test by contributing small amounts of money to NHCEs who have very low compensation for the plan year (for example, an employee who terminated employment in early January with \$300 of compensation). This is because of the fact that the ADP test is based on an unweighted average of ADRs and a small dollar (but high percentage of compensation) contribution to a terminated or other partial-year employee has a larger impact on the ADP test than the same contribution to a full-year employee.

The IRS and Treasury have been concerned that, by using this type of technique, employers may pass the ADP test by making high percentage QNECs to a small number of employees with low compensation rather than providing contributions to a broader group of NHCEs. In addition, the legislative his-

tory to EGTRRA expresses Congressional intent that the Secretary of the Treasury will use his existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the ADP of the NHCEs. (See EGTRRA Conference Report, H.R. Conf. Rep. 107-84, 240).

Accordingly, the proposed regulations added a new requirement that a QNEC must satisfy in order to be taken into account under the ADP test. This requirement, designed to limit the use of targeted QNECs, generally prohibited a plan from counting QNECs for purposes of the ADP test to the extent that QNECs are more than double the QNECs at least half of the other NHCEs are receiving, when expressed as a percentage of compensation.

The restriction on targeting QNECs is implemented by providing that a QNEC for an NHCE that exceeds 5% of compensation could be taken into account for the ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's representative contribution rate. The plan's representative contribution rate is defined as the lowest contribution rate (*i.e.*, the sum of QNECs made and QMACs taken into account for an employee divided by the employee's compensation) among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or the lowest contribution rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater).

While some commentators applauded the restriction on targeted QNECs, a number of commentators suggested that certain types of contributions be exempted from the definition of targeted QNECs. In particular, commentators suggested that QNECs equal to a flat dollar amount that are made to all NHCEs and QNECs that are made in connection with an employer's obligation to pay a prevailing wage under the Davis-Bacon Act (46 Stat. 1494), Public Law 71-798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89-386, or similar legislation should be able to be taken into account under the ADP test (even though such contributions create

widely different contribution percentages among the NHCE population) because they are not "targeted".

After reviewing the comments, the IRS and Treasury believe that the restrictions on targeting QNECs should apply essentially as they were proposed. While flat dollar QNEC contributions may not have the appearance of targeting, allowing those contributions to skew the results of the ADP test undermines the integrity of the ADP test. However, the final regulations provide more flexibility for QNECs that are made in connection with an employer's obligation to pay a prevailing wage under the Davis-Bacon Act (46 Stat. 1494), Public Law 71-798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89-286, or similar legislation by allowing a QNEC of up to 10% of compensation to be taken into account under the ADP test in such a case.

The final regulations under section 401(m) provide parallel restrictions on QNECs taken into account in ACP testing, and a QNEC cannot be taken into account under both the ADP and ACP test (including for purposes of determining the representative contribution rate). As discussed more fully below, the final regulations generally retain the proposed regulations limitation on targeting matching contributions, which limits the extent to which QMACs can be targeted as a means of avoiding the restrictions on targeted QNECs.

#### D. Correction

Section 401(k)(8)(C), as amended by SBJPA, provides that, for purposes of correcting a plan's failure to meet the nondiscrimination requirements of section 401(k)(3), the distribution of excess contributions is made on the basis of the amount of the contributions by, or on behalf of, each HCE. The final regulations implement this correction procedure in the same manner as set forth in Notice 97-2. Thus, the total amount of excess contributions is determined using the rules under the pre-SBJPA regulations (*i.e.*, based on high percentages). Then, that total amount is apportioned among the HCEs by assigning the excess to be distributed

<sup>5</sup> With respect to this timing requirement, it should be noted that in order to be taken into account for purposes of section 415(c) for a limitation year, the contributions will need to be made within the time frame set forth in the regulations under section 415 (generally, no later than 30 days after the end of the section 404(a)(6) period applicable to the taxable year with or within which the limitation year ends).



first to those HCEs who have the greatest dollar amount of contributions taken into account under the ADP test (as opposed to the highest deferral percentage). If these amounts are distributed or recharacterized in accordance with these regulations, the plan complies with the ADP test for the plan year with no obligation to recalculate the ADP test.

The final regulations generally follow the rules in the proposed regulations on the determination of net income attributable to excess contributions. However, the regulatory language regarding the calculation of gap period income (*i.e.*, income for the period after the plan year) has been clarified to specify that gap period income needs to be included only to the extent the employee is or would be credited with allocable gain or loss on those excess contributions for that period, if the total account were to be distributed. In addition, in response to administrative concerns raised by comments, the final regulations provide that a distribution of excess contributions is not required to include the income allocable to the excess contributions for a period that is no more than 7 days before the distribution. As under the pre-SBJPA regulations, the determination of the income for the gap period could be based on the income determined using the alternative method for the aggregate of the plan year and the gap period or using 10% of the income for the plan year (determined under the alternative method) for each month in the gap period.

The final regulations retain the rules in the proposed regulations regarding the timing and tax treatment of distributions of excess contributions, coordination with the distribution of excess deferrals and the treatment of matches attributable to excess contributions. However, the final regulations clarify that if excess contributions are distributed, they are includible in income on the dates the elective contributions would have been received by the employee had the employee originally elected to receive the amounts in cash, treating the excess contributions that are being distributed as the first elective contributions for the plan year.

#### 4. Safe Harbor Section 401(k) Plans

Section 401(k)(12) provides a design-based safe harbor method under

which a CODA is treated as satisfying the ADP test if the arrangement meets certain contribution and notice requirements. Section 1.401(k)-3 of these final regulations, which sets forth the requirements for these arrangements, generally follows the rules set forth in Notice 98-52 and Notice 2000-3. Thus, a plan satisfies the section 401(k) safe harbor if it makes specified QMACs for all eligible NHCEs. The matching contributions can be under a basic matching formula that provides for QMACs equal to 100% of the first 3% of elective contributions and 50% of the next 2% or an enhanced matching formula that is at least as generous in the aggregate, provided the rate of matching contributions under the enhanced matching formula does not increase as the employee's rate of elective contributions increases. In lieu of QMACs, the plan is permitted to provide QNECs equal to 3% of compensation for all eligible NHCEs. In addition, notice must be provided to each eligible employee, within a reasonable time before the beginning of the year, of the employee's right to defer under the plan.

The proposed regulations did not include any exception to the requirements for safe harbor matching contributions with respect to catch-up contributions. As part of the proposed regulations the IRS and Treasury solicited comments on the specific circumstances under which elective contributions by an NHCE to a safe harbor plan would be less than the amount required to be matched, *e.g.*, less than 5% of safe harbor compensation, but would be treated by the plan as catch-up contributions, and on the extent to which a safe harbor plan should be required to match catch-up contributions under such circumstances. After reviewing the comments and the applicable statutory provisions (including the amendments to section 414(v)(3)(B) made by the Job Creation and Worker Assistance Act of 2002, (JCWAA) (Public Law 107-147)), the IRS and Treasury have determined that no such exception is appropriate.

Section 401(k)(12)(D) contains a requirement that each eligible employee be provided with a written notice of the employee's rights and obligations under the plan. These final regulations provide that the notice can be provided in writing or through another medium that is pre-

scribed by the Commissioner as satisfying the requirement for a written notice. As reflected in the priority guidance plan, the IRS and Treasury are currently developing guidance setting forth the extent to which the notice described in section 401(k)(12)(D), as well as other notices under the various requirements relating to qualified retirement plans, can be provided electronically, taking into account the effect of the Electronic Signatures in Global and National Commerce Act (E-SIGN) (114 Stat. 464), Public Law 106-229. Until that guidance is issued, plan administrators and employers may continue to rely on the interim guidance in Q&A-7 of Notice 2000-3 on the use of electronic media to satisfy the notice requirement in section 401(k)(12)(D).

These final regulations specify that a section 401(k) safe harbor plan must generally be adopted before the beginning of the plan year and be maintained throughout a full 12-month plan year. This requirement is consistent with the notion that the statute specifies a certain contribution level for NHCEs in order to be deemed to pass the nondiscrimination requirements. If the contribution level is not maintained for a full 12-month year, the employer contributions made on behalf of NHCEs should not support what could be a full year's contribution by the HCEs.

The final regulations adopt the exceptions to this 12-month rule that were set forth in the proposed regulations. Thus, a section 401(k) safe harbor plan could have a short plan year in the year the plan terminates, provided the plan termination is in connection with a merger or acquisition involving the employer, or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d). A section 401(k) safe harbor plan could also have a short plan year in the year the plan terminates (without regard to the reason for the termination or the financial condition of the employer) if the employer makes the safe harbor contributions for the short year, employees are provided notice of the change, and the plan passes the ADP test. In either case, the employer must make the safe harbor contributions through the date of plan termination.

In addition, a safe harbor plan could have a short plan year if it is preceded and followed by plan years as a section 401(k)

safe harbor plan. Under these final regulations, the following plan year is permitted to be shorter than 12 months if the short plan year is as a result of a plan termination (whether or not the plan termination is in connection with a merger or acquisition involving the employer). These final regulations clarify that this treatment is unavailable if in the following plan year safe harbor matching contributions are reduced or suspended. In the event that the short plan year is followed by another short plan year, this treatment is available if the plan satisfies the 401(k) safe harbor requirements for the 12 month period immediately following the first short plan year.

### 5. SIMPLE 401(k) Plans

Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the requirements of section 401(k)(3)(A)(ii) if the contribution, vesting, notice and exclusive plan requirements of section 401(k)(11) are satisfied. Section 1.401(k)-4 of these regulations reflects the provisions of section 401(k)(11) in a manner that follows the positions reflected in the model amendments set forth in Rev. Proc. 97-9.

### 6. Matching Contributions and Employee Contributions

Section 401(m)(2) sets forth a nondiscrimination test, the ACP test, with respect to matching contributions and employee contributions that is parallel to the nondiscrimination test for elective contributions set forth in section 401(k). Section 1.401(m)-1 of the regulations sets forth this test in a manner that is consistent with the nondiscrimination test set forth in §1.401(k)-1(b). Thus, satisfaction of the ACP test, the ACP safe harbor or the SIMPLE 401(k) provisions is the exclusive means that can be used to satisfy the nondiscrimination in amount of contribution requirements of section 401(a)(4) with respect to employee contributions and matching contributions. An anti-abuse provision comparable to that provided in connection with the regulations under section 401(k) limits the ability of an employer to make repeated changes in plan provisions or testing procedures that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise

manipulate the nondiscrimination rules of section 401(m), if a principal purpose of the changes was to achieve such a result.

The final regulations also include provisions regarding plan aggregation and disaggregation that are similar to those that apply for CODAs under section 401(k). For example, matching contributions made under the portion of a plan that is an ESOP and the portion of the same plan that is not an ESOP are not disaggregated under these final regulations.

The definitions of matching contribution and employee contribution under §1.401(m)-1 of the regulations generally follow the definitions in the pre-SBJPA regulations. Thus, whether an employer contribution is on account of an elective deferral or employee contribution — and thus is a matching contribution — is determined based on all the relevant facts and circumstances.

The final regulations generally follow the proposed regulations in providing that a contribution is not treated as a matching contribution on account of an elective deferral if it is contributed before the employee's performance of services with respect to which the elective deferral is made (or when the cash that is subject to the cash or deferred election would be currently available, if earlier) and an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution. Thus, under these regulations, an employer would not be able to prefund matching contributions to accelerate the deduction for those contributions; and, as noted above with respect to the timing of elective contributions, employer contributions made under the facts in Notice 2002-48 would not be taken into account under the ACP test and would not satisfy any plan requirement to provide matching contributions.

However, in response to comments, the final regulations make an exception to this prefunding restriction for forfeitures and for contributions that result in a matching allocation of employer securities released from encumbrance under a securities acquisition loan in a leveraged ESOP, provided that the contributions are for a required payment that is due under the loan terms and are not made early with a principal purpose of accelerating deductions.

### 7. ACP Test for Matching Contributions and Employee Contributions

Section 1.401(m)-2 of the final regulations provides rules for the ACP test that generally parallel the rules applicable to the ADP test in §1.401(k)-2. Thus, for example, the ACP test may be run by comparing the ACP for eligible HCEs for the current year with the ACP for eligible NHCEs for either the current plan year or the prior plan year. The determination of the actual contribution ratio (ACR) for an eligible employee, and the contributions that are taken into account in determining that ACR, under the final regulations are comparable to the rules under the section 401(k) regulations. Thus, for example, the ACR for an HCE who has matching contributions or employee contributions under two or more plans is determined by adding together matching contributions and employee contributions under all plans of the employer during the plan year of the plan being tested, in a manner comparable to that for determining the ADR of an HCE who participates in two or more CODAs.

The final regulations allow QNECs to be taken into account for ACP testing, but would provide essentially the same restrictions on targeting QNECs to a small number of NHCEs as is provided in §1.401(k)-2. The only difference in the rules is that the contribution percentages used to determine the lowest contribution percentage is based on the sum of the QNECs and those matching contributions taken into account in the ACP test, rather than the sum of the QNECs and the QMACs taken into account under the ADP test. Because QNECs that do not exceed 5% are not subject to the limits on targeted QNECs under either the ADP test or the ACP test, an employer is permitted to take into account up to 10% in QNECs for an eligible NHCE, 5% in ADP testing and 5% in ACP testing, without regard to how many NHCEs receive QNECs (with each of those numbers doubled for QNECs that are made in connection with an employer's obligation to provide a prevailing wage under the Davis-Bacon Act (46 Stat. 1494), Public Law 71-798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89-286, or similar legislation).

In addition, to prevent an employer from using targeted matching contributions to circumvent the limitation on tar-

geted QNECs, the proposed regulations provided a parallel rule to limit targeted matching contributions for NHCEs from being taken into account in the ACP test to the extent the matching rate for the contribution exceeds the greater of 100% and 2 times the representative matching rate. These final regulations retain this basic rule with modifications to make it more consistent with the rule for QNECs. First, similar to the rule for QNECs, under these final regulations, a contribution that matches an elective contribution may be taken into account to the extent it does not exceed the greater of 5% of compensation. Only then does the rate of matching contribution rate become relevant. Further, in determining the representative matching rate these final regulations provide a new rule if the matching rate is not the same for all levels of elective contributions for an employee. In that case, the employee's matching rate is determined assuming that an employee's elective deferrals are equal to 6 percent of compensation. There is also a parallel rule for matching contributions for employee contributions.

### 8. *Changes to other regulations*

These regulations include a number of cross-reference changes to other regulations to reflect the structure of these final regulations. However, no changes were made to the regulations under section 401(a)(26) and the rule relating to treating matching contributions as employer contributions for purposes of section 416 (see §1.416-1, Q&A M-19) because these regulations have not been updated to reflect recent statutory changes.

### **Effective Date**

These final regulations apply for plan years beginning on or after January 1, 2006. However, plan sponsors are permitted to apply these final regulations to any plan year that ends after December 29, 2004, provided the plan applies all the rules of these final regulations, to the extent applicable, for that plan year and all subsequent plan years. Taxpayers are

cautioned, however, that a decision to apply these regulations in the middle of a plan year could only be successfully implemented if the plan has been operated in accordance with these regulations for that year.

For plan years beginning before the effective date of these regulations with respect to a plan, the plan must apply the rules of the prior regulations (as they appeared in the April 1, 2004 edition of 26 CFR part 1), the statutory provisions of section 401(k) and (m), and applicable IRS notices.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the conclusion that few plans containing qualified cash or deferred arrangements will correct excess contributions through the recharacterization of these amounts as employee contributions under §1.401(k)-2(b)(3) of these regulations. The collection of information contained in §1.401(k)-3(d), (f), and §1.401(m)-3(e) are required by statutory provisions. However, the IRS has considered alternatives that would lessen the impact of these statutory requirements on small entities. Thus, the collection of information in these regulations will only have a minimal economic impact on most small entities. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Drafting Information**

The principal authors of these regulations are R. Lisa Mojiri-Azad and John T. Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

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### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 601 are amended to read as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

§1.401(k)-1 also issued under 26 U.S.C. 401(m)(9).

§1.401(k)-2 also issued under 26 U.S.C. 401(m)(9).

§1.401(k)-3 also issued under 26 U.S.C. 401(m)(9).

§1.401(k)-4 also issued under 26 U.S.C. 401(m)(9).

§1.401(k)-5 also issued under 26 U.S.C. 401(m)(9).

§1.401(k)-6 also issued under 26 U.S.C. 401(m)(9).

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§1.401(m)-1 also issued under 26 U.S.C. 401(m)(9).

§1.401(m)-2 also issued under 26 U.S.C. 401(m)(9).

§1.401(m)-3 also issued under 26 U.S.C. 401(m)(9).

§1.401(m)-4 also issued under 26 U.S.C. 401(m)(9).

§1.401(m)-5 also issued under 26 U.S.C. 401(m)(9).

\* \* \* \* \*

Par. 2. For each section set forth below, remove the text that appears in the column labeled "Remove" and replace with the text that appears in the column labeled "Insert":

Regulation cite	Remove	Insert
§1.72(p)-1, Q&A-12	“1.401(k)-1(d)(6)(ii)”	“1.401(k)-1(d)(5)(iii)”
§1.401(a)(4)-1(b)(2)(ii)(B)	“1.401(k)-1(b)(4)”	“1.401(k)-2(a)(5)(i)”
§1.401(a)(4)-1(b)(2)(ii)(B)	“1.401(k)-1(b)(4)(i)”	“1.401(k)-2(a)(4)(i)”
§1.401(a)(4)-1(b)(2)(ii)(B)	“1.401(m)-1(b)(4)(ii)(A)”	“1.401(m)-2(a)(4)(iii)”
§1.401(a)(4)-1(b)(2)(ii)(B)	“1.401(k)-1(b)(5)”	“1.401(k)-2(a)(6)”
§1.401(a)(4)-1(b)(2)(ii)(B)	“1.401(m)-1(b)(5)”	“1.401(m)-2(a)(6)”
§1.401(a)(4)-4(e)(3)(iii)(D)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.401(a)(4)-4(e)(3)(iii)(F)	“1.401(m)-1(f)(6)”	“1.401(m)-1(a)(3)”
§1.401(a)(4)-4(e)(3)(iii)(G)	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.401(a)(4)-4(e)(3)(iii)(G)	“1.401(k)-1(f)(1)(i)”	“1.401(k)-2(b)(1)(i)”
§1.401(a)(4)-4(e)(3)(iii)(G)	“1.401(m)-1(e)(1)(i), and 1.401(m)-2(c)”	“1.401(m)-2(b)(1)(i)”
§1.401(a)(4)-9(c)(3)(ii)	“1.401(k)-1(b)(3)(ii) and 1.401(m)-1(b)(3)(ii)”	“1.401(k)-1(b)(4)(iv)(B) and 1.401(m)-1(b)(4)(iv)(B)”
§1.401(a)(4)-11(g)(3)(vii)(A)	“1.401(k)-1(g)(13)(ii)”	“1.401(k)-6”
§1.401(a)(4)-11(g)(3)(vii)(A)	“1.401(k)-1(g)(4)”	“1.401(k)-6”
§1.401(a)(4)-11(g)(3)(vii)(A)	“1.401(m)-1(f)(4)”	“1.401(m)-5”
§1.401(a)(4)-11(g)(6), Example 7	“1.401(k)-1(f)”	“1.401(k)-2(b)”
§1.401(a)(17)-1(b)(3)(iii)(B)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.401(a)(17)-1(b)(3)(iii)(B)	“1.401(m)-1(f)(12)”	“1.401(m)-5”
§1.401(a)(17)-1(b)(3)(iii)(B)	“1.401(m)-1(f)(6)”	“1.401(m)-5”
§1.401(a)(17)-1(d)(5)(ii)	“1.401(m)-(f)(6)”	“1.401(m)-1(a)(3)”
§1.401(l)-1(a)(4)(iii)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.401(l)-1(a)(4)(iii)	“1.401(m)-1(f)(6) or (f)(12)”	“1.401(m)-1(a)(3) or (a)(2)”
§1.402(a)-1(d)(1)	“1.401(k)-1(a)(3)(iii) and (2)(i)”	“1.401(k)-1(a)(3)(iv) and (2)(iv)”
§1.402(a)-1(d)(2)(i)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.402(a)-1(d)(2)(i)	“1.401(k)-1(a)(4)(i)”	“1.401(k)-1(a)(4)(i)”
§1.402(a)-1(d)(2)(i)	“1.401(k)-1(a)(7)”	“1.401(k)-1(a)(5)(iv)(B)”
§1.402(a)-1(d)(2)(ii)	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.402(a)-1(d)(2)(iii)	“1.401(k)-1(a)(4)(iv)”	“1.401(k)-1(a)(3)(v)”
§1.402(a)-1(d)(2)(iii)	“1.401(k)-1(a)(6)(ii)(C)”	“1.401(k)-1(a)(3)(v)(B)”
§1.402(a)-1(d)(3)(ii)(A)	“1.401(k)-(g)(12)”	“1.401(k)-6”
§1.402(a)-1(d)(3)(iv)	“1.401(k)-1(a)(7)”	“1.401-1(a)(5)(iv)(B)”
§1.402(c)-2, Q&A-4(c)	“1.401(k)-1(f)”	“1.401(k)-2(b)(2)”
§1.402(c)-2, Q&A-4(c)	“1.401(m)-1(e)(3)”	“1.401(m)-2(b)(2)”
§1.402(g)-1(c)(2)	“1.401(k)-1(a)(3)(iv)”	“1.401(k)-1(a)(3)(v)”
§1.402(g)-1(e)(6)	“1.401(k)-1(f)(5)(i)”	“1.401(k)-2(b)(4)(i)”
§1.410(b)-3(a)(3), Example 2	“1.401(k)-1(g)(4)”	“1.401(k)-6”
§1.410(b)-3(a)(3), Example 3	“1.401(m)-1(f)(4)”	“1.401(m)-5”

Regulation cite	Remove	Insert
§1.410(b)-7(c)(1)	“1.401(k)-1(b)(4)(iv)”	“1.401(k)-2(a)(5)”
§1.410(b)-9	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.410(b)-9	“1.401(k)-1(a)(4)(i)”	“1.401(k)-1(a)(4)(i)”
§1.410(b)-9	“1.401(k)-1(b)(5)”	“1.401(k)-1(a)(6)”
§1.410(b)-9	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.410(b)-9	“1.401(m)-1(e)(1)”	“1.401(m)-2(b)(1)”
§1.410(b)-9	“1.401(k)-1(f)(2)”	“1.401(k)-6”
§1.410(b)-9	“1.401(m)-1(f)(8)”	“1.401(m)-5”
§1.411(a)-4(b)(7)	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.411(a)-4(b)(7)	“1.401(m)-1(e)(1)”	“1.401(m)-2(b)(1)”
§1.411(a)-4(b)(7)	“1.401(k)-1(f)(2) and (g)(7)”	“1.401(k)-2(b)(2)(ii) and §1.401(k)-6”
§1.411(a)-4(b)(7)	“1.401(m)-1(f)(8)”	“1.401(m)-5”
§1.411(d)-4(d), Q&A-2(b)(2)(x)	“1.401(k)-1(d)(2)”	“1.401(k)-1(d)(3)”
§1.411(d)-4(d), Q&A-2(b)(2)(x)	“1.401(k)-1(d)(2)”	“1.401(k)-1(d)(3)”
§1.414(r)-5(g)(2)(iv)(A)	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.414(r)-5(g)(2)(iv)(A)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§1.414(r)-5(g)(2)(iv)(B)	“1.401(m)-1(f)(12)”	“1.401(m)-1(a)(2)”
§1.414(r)-5(g)(3)(iv)	“1.401(k)-1(g)(3)”	“1.401(k)-6”
§54.4979-1(b)(1)	“1.401(m)-1(f)(8)”	“1.401(m)-5”
§54.4979-1(b)(2)	“1.401(k)-1(g)(7)”	“1.401(k)-6”
§54.4979-1(c)(1)	“1.401(k)-1(b)(5)”	“1.401(k)-2(a)(6)”
§54.4979-1(c)(1)	“1.401(m)-1(b)(5)”	“1.401(m)-2(a)(6)”
§54.4979-1(c)(1)	“1.401(k)-1(f)(1)(i) and (6)(i)”	“1.401(m)-2(b)(1)(i) and (5)(i)”
§54.4979-1(c)(1)	“1.401(m)-1(e)(1)(i)”	“1.401(m)-2(b)(1)(i)”
§54.4979-1(c)(2)	“1.401(k)-1(f)(1)(i) and (6)(i)”	“1.401(k)-2(b)(1)(i) and (6)(i)”
§54.4979-1(c)(2)	“1.401(k)-1(f)(3)(ii) and (4)(v)”	“1.401(k)-2(b)(3)(ii) and (2)(vi)”
§54.4979-1(c)(2)	“1.401(m)-1(e)(3)(v)”	“1.401(m)-2(b)(2)(vi)”
§54.4979-1(c)(3)	“1.401(k)-1(f)(4)(ii)”	“1.401(k)-2(b)(2)(iv)”
§54.4979-1(c)(3)	“1.401(m)-1(e)(3)(ii)”	“1.401(m)-2(b)(2)(iv)”

Par. 3. In §1.410(b)-3, paragraph (a)(2)(i) is revised to read as follows:

*Employees and former employees who benefit under a plan.*

(a) \* \* \*

(2) \* \* \* (i) *Exceptions to allocation or accrual requirement*—(i) *Section 401(k) and 401(m) plans.* Notwithstanding paragraph (a)(1) of this section, an employee is treated as benefiting under a section 401(k) plan for a plan year if and only if the employee is an eligible employee as defined in §1.401(k)-6 under the plan. Similarly, an employee is treated as benefiting un-

der a section 401(m) plan for a plan year if and only if the employee is an eligible employee as defined in §1.401(m)-5 under the plan for the plan year.

\* \* \*

Par. 4. Sections 1.401(k)-0 and 1.401(k)-1 are revised and §§1.401(k)-2 through 1.401(k)-6 are added to read as follows:

*§1.401(k)-0 Table of contents.*

This section contains first a list of section headings and then a list of the para-

graphs in each section in §§1.401(k)-1 through 1.401(k)-6.

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§1.401(k)-3 Safe harbor requirements.

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§1.401(k)-6 Definitions.

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*§1.401(k)-5 Special rules for mergers, acquisitions and similar events. [Reserved].*

*§1.401(k)-6 Definitions.*

*§1.401(k)-1 Certain cash or deferred arrangements.*

(a) *General rules*—(1) *Certain plans permitted to include cash or deferred arrangements.* A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan

includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) *Rules applicable to cash or deferred arrangements generally*—(i) *Definition of cash or deferred arrangement.* Except as provided in paragraphs (a)(2)(ii) and (iii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) *Treatment of after-tax employee contributions.* A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (e.g., by treating the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). A designated Roth contribution, however, is not treated as an after-tax contribution for purposes of this section, §1.401(k)-2 through §1.401(k)-6 and §1.401(m)-1 through §1.401(m)-5. A contribution can be an after-tax employee contribution under the rule of this paragraph (a)(2)(ii) even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) *Treatment of ESOP dividend election.* A cash or deferred arrangement does not include an arrangement under an ESOP under which dividends are either distributed or invested pursuant to an election made by participants or their beneficiaries in accordance with section 404(k)(2)(A)(iii).

(iv) *Treatment of elective contributions as plan assets.* The extent to which elective contributions constitute plan assets for purposes of the prohibited transaction provisions of section 4975 and Title I of the Employee Retirement Income Security Act of 1974 (88 Stat. 829), Public Law 93-406, is determined in accordance with regulations and rulings issued by



the Department of Labor. See 29 CFR 2510.3-102.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either—

(A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or

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

(ii) *Automatic enrollment.* For purposes of determining whether an election is a cash or deferred election, it is irrelevant whether the default that applies in the absence of an affirmative election is described in paragraph (a)(3)(i)(A) of this section (*i.e.*, the employee receives an amount in cash or some other taxable benefit) or in paragraph (a)(3)(i)(B) of this section (*i.e.*, the employer contributes an amount to a trust or provides an accrual or other benefit under a plan deferring the receipt of compensation).

(iii) *Rules related to timing*—(A) *Requirement that amounts not be currently available.* A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(B) *Contribution may not precede election.* A contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made.

(C) *Contribution may not precede services*—(1) *General rule.* Contributions are made pursuant to a cash or deferred election only if the contributions are made after the employee's performance of service with respect to which the contributions are made (or when the cash or other taxable benefit would be currently available, if earlier).

(2) *Exception for bona fide administrative considerations.* The timing of contributions will not be treated as failing to satisfy the requirements of this paragraph

(a)(3)(iii)(C) merely because contributions for a pay period are occasionally made before the services with respect to that pay period are performed, provided the contributions are made early in order to accommodate *bona fide* administrative considerations (for example, the temporary absence of the bookkeeper with responsibility to transmit contributions to the plan) and are not paid early with a principal purpose of accelerating deductions.

(iv) *Current availability defined.* Cash or another taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(v) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in section 219(g)(5)(A) (whether or not such other plan or arrangement has terminated), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans or arrangements of the employer (including plans or arrangements not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Thus, for example, employer contributions made pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant

to a cash or deferred election and are not includible in an employee's gross income by reason of §1.402(a)-1(d). In the case of an irrevocable election made on or before December 23, 1994—

(A) The election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because an employee was previously eligible under another plan of the employer (whether or not such other plan has terminated); and

(B) In the case of a plan in which partners may participate, the election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because the election was made after commencement of employment or after the employee's first becoming eligible under any plan of the employer, provided that the election was made before the first day of the first plan year beginning after December 31, 1988, or, if later, March 31, 1989.

(vi) *Tax treatment of employees.* An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for section 402(e)(3), an employee is treated as having received an amount that is contributed to an exempt trust or plan described in section 401(a) or 403(a) pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See §1.402(a)-1(d).

(vii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

*Example 1.* (i) An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10% of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30.

(ii) An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

*Example 2.* (i) An employer maintains a profit-sharing plan which provides for discretionary profit sharing contributions and under which each eligible employee may elect to reduce his compensation by up to 10% and to have the employer contribute such amount to the plan. The employer pays each employee every two weeks for services during the imme-

diately preceding two weeks. The employee's election to defer compensation for a payroll period must be made prior to the date the amount would otherwise be paid. The employer contributes to the plan the amount of compensation that each employee elected to defer, at the time it would otherwise be paid to the employee, and does not treat the contribution as an after-tax employee contribution.

(ii) The election is a cash or deferred election and the contributions are elective contributions.

*Example 3.* (i) The facts are the same as in *Example 2*, except that the employer makes a \$10,000 contribution on January 31 of the plan year that is in addition to the contributions that satisfy the employer's obligation to make contributions with respect to cash or deferred elections for prior payroll periods. Employee A makes an election on February 15 to defer \$2,000 from compensation that is not currently available and the employer reduces the employee's compensation to reflect the election.

(ii) None of the additional \$10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election, because the contribution was made before the election was made. Accordingly, the employer must make an additional contribution of \$2,000 in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The \$10,000 contribution may be allocated under the plan terms providing for discretionary profit sharing contributions.

*Example 4.* (i) The facts are the same as in *Example 3*, except that Employee A had an outstanding election to defer \$500 from each payroll period's compensation. The \$10,000 additional payment that is contributed early is not made early in order to accommodate *bona fide* administrative considerations.

(ii) None of the additional \$10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election for future payroll periods, because the contribution was made before the earlier of Employee A's performance of services to which the contribution is attributable or when the compensation would be currently available. Furthermore, the exception for early contributions in paragraph (a)(3)(iii)(C)(2) of this section does not apply. Accordingly, the employer must make an additional contribution of \$500 per payroll period in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The \$10,000 contribution may be allocated under the plan terms providing for discretionary profit sharing contributions.

*Example 5.* (i) Employer B establishes a money purchase pension plan in 1986. This is the first qualified plan established by Employer B. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 2000, Employer B establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer B permits all employees on the effective date of the profit-sharing plan to make a one-time irrevocable election to have Employer B contribute 5% of compensation on their behalf to the plan and make no other contribution to any other plan of Employer B (including plans not yet established) for the duration of the employee's employment with Employer B, and have their salaries reduced by 5%.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within

the meaning of paragraph (a)(3)(v) of this section with respect to the salaried employees of Employer B who, before becoming eligible to participate under the profit-sharing plan, became eligible to participate under the money purchase pension plan. The election under the profit-sharing plan is a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the hourly employees, because they were not previously eligible to participate under another plan of the employer.

(4) *Rules applicable to qualified cash or deferred arrangements*—(i) *Definition of qualified cash or deferred arrangement.* A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section.

(ii) *Treatment of elective contributions as employer contributions.* Except as otherwise provided in §1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement (including designated Roth contributions) are treated as employer contributions. Thus, for example, elective contributions under such an arrangement are treated as employer contributions for purposes of sections 401(a), 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees.* Except as provided in section 402(g), 402A (effective for taxable years beginning after December 31, 2005), or §1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See §1.402(a)–1(d)(2)(i).

(iv) *Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement*—(A) *Exclusive means of amounts testing.* Elective contributions (including elective contributions that are designated Roth contributions) under a qualified cash or deferred arrangement satisfy the requirements of section 401(a)(4) with respect to amounts if and only if the amount of elective contributions satisfies the nondiscrimination test of section 401(k) under paragraph (b)(1) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B).

(B) *Testing benefits, rights and features.* A plan that includes a qualified cash or deferred arrangement must sat-

isfy the requirements of section 401(a)(4) with respect to benefits, rights and features in addition to the requirements regarding amounts described in paragraph (a)(4)(iv)(A) of this section. For example, the right to make each level of elective contributions under a cash or deferred arrangement and the right to make designated Roth contributions are rights or features subject to the requirements of section 401(a)(4). See §1.401(a)(4)–4(e)(3)(i) and (iii)(D). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor HCEs with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4).

(C) *Minimum coverage requirement.* A qualified cash or deferred arrangement is treated as a separate plan that must satisfy the requirements of section 410(b). See §1.410(b)–7(c)(1) for special rules. The determination of whether a cash or deferred arrangement satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. See also §1.401(a)(4)–11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(5) *Rules applicable to nonqualified cash or deferred arrangements*—(i) *Definition of nonqualified cash or deferred arrangement.* A nonqualified cash or deferred arrangement is a cash or deferred arrangement that fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section.

(ii) *Treatment of elective contributions as nonelective contributions.* Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions under such an arrangement are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412,

415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) *Tax treatment of employees.* Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income. See §1.402(a)-1(d)(1).

(iv) *Qualification of plan that includes a nonqualified cash or deferred arrangement—* (A) *In general.* A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the nondiscrimination tests of sections 401(k), paragraph (b)(1) of this section, section 401(m)(2) and §1.401(m)-1(b) may not be used. See §§1.401(a)(4)-1(b)(2)(ii)(B) and 1.410(b)-9 (definition of section 401(k) plan).

(B) *Application of section 401(a)(4) to certain plans.* The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan that automatically satisfies the requirements of section 410(b). See §§1.401(a)(4)-1(c)(5) and 1.410(b)-2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof). See sections 401(a)(5) and 410(c)(1)(A).

(v) *Example.* The following example illustrates the application of this paragraph (a)(5):

*Example.* (i) For the 2006 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement do not satisfy the nondiscrimination test of section 401(k) and paragraph (b) of this section.

(ii) The arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions under paragraph (a)(5)(ii) of this section. Under paragraph (a)(5)(iii) of this section

and under §1.402(a)-1(d)(1), however, the elective contributions are includible in each employee's gross income.

(6) *Rules applicable to cash or deferred arrangements of self-employed individuals—*(i) *Application of general rules.* Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf. Consistent with §1.402(a)-1(d), the elective contributions under such an arrangement are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement (*i.e.*, the requirements of section 401(k) and this section are satisfied). Also, even if the arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also §1.401(a)-30.

(ii) *Treatment of matching contributions made on behalf of self-employed individuals.* Under section 402(g)(8), matching contributions made on behalf of a self-employed individual are not treated as elective contributions made pursuant to a cash or deferred election, without regard to whether such matching contributions indirectly permit individual partners to vary the amount of contributions made on their behalf.

(iii) *Timing of self-employed individual's cash or deferred election.* For purposes of paragraph (a)(3)(iv) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year and a sole proprietor's compensation is deemed currently available on the last day of the individ-

ual's taxable year. Accordingly, a self-employed individual may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship taxable year after the last day of that year. See §1.401(k)-2(a)(4)(ii) for the rules regarding when these contributions are treated as allocated.

(iv) *Special rule for certain payments to self-employed individuals.* For purposes of sections 401(k) and 401(m), the earned income of a self-employed individual for a taxable year constitutes payment for services during that year. Thus, for example, if a partnership provides for cash advance payments during the taxable year to be made to a partner based on the value of the partner's services prior to the date of payment (and which do not exceed a reasonable estimate of the partner's earned income for the taxable year), a contribution of a portion of these payments to a profit sharing plan in accordance with an election to defer the portion of the advance payments does not fail to be made pursuant to a cash or deferred election within the meaning of paragraph (a)(3)(iii) of this section merely because the contribution is made before the amount of the partner's earned income is finally determined and reported. However, see §1.401(k)-2(a)(4)(ii) for rules on when earned income is treated as received.

(b) *Coverage and nondiscrimination requirements—*(1) *In general.* A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if—

(i) The group of eligible employees under the cash or deferred arrangement (including any employees taken into account for purposes of section 410(b) pursuant to §1.401(a)(4)-11(g)(3)(vii)(A)) satisfies the requirements of section 410(b) (including the average benefit percentage test, if applicable); and

(ii) The cash or deferred arrangement satisfies—

(A) The ADP test of section 401(k)(3) described in §1.401(k)-2;

(B) The ADP safe harbor provisions of section 401(k)(12) described in §1.401(k)-3; or

(C) The SIMPLE 401(k) provisions of section 401(k)(11) described in §1.401(k)-4.

(2) *Automatic satisfaction by certain plans.* Notwithstanding paragraph (b)(1) of this section, a governmental plan

(within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof) shall be treated as meeting the requirements of this paragraph (b).

(3) *Anti-abuse provisions.* This section and §§1.401(k)-1 through 1.401(k)-6 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring—(i) In general.* This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans and cash or deferred arrangements for purposes of this section, and §§1.401(k)-2 through 1.401(k)-6.

(ii) *Aggregation of cash or deferred arrangements within a plan.* Except as otherwise specifically provided in this paragraph (b)(4), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement and a plan must apply a single test under paragraph (b)(1)(ii) of this section with respect to all such arrangements within the plan. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, all contributions under both cash or deferred arrangements must be treated as made under a single cash or deferred arrangement subject to a single test, even if they have significantly different features, such as different limits on elective contributions.

(iii) *Aggregation of plans—(A) In general.* For purposes of this section and §§1.401(k)-2 through 1.401(k)-6, the term *plan* means a plan within the meaning of §1.410(b)-7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)-7(c), and the permissive aggregation rules of §1.410(b)-7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)-7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)-7(d) are treated as a single plan for purposes of sections 401(k) and (m).

(B) *Plans with inconsistent ADP testing methods.* Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all cash or deferred arrangements under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)-7(d), an employer may not aggregate plans (within the meaning of §1.410(b)-7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)-7(b)) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)-7(b)) using the ADP safe harbor provisions of section 401(k)(12) and another plan that is using the ADP test of section 401(k)(3).

(iv) *Disaggregation of plans and separate testing—(A) In general.* If a cash or deferred arrangement is included in a plan (within the meaning of §1.410(b)-7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the cash or deferred arrangement must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a cash or deferred arrangement are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(k), unless the employer is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to

the plan. Similarly, if a cash or deferred arrangement under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the arrangement must be treated as two separate arrangements, one comprising all eligible employees who have met the age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the age and service requirements under section 410(a)(1), unless the plan is using the rule in §1.401(k)-2(a)(1)(iii)(A).

(B) *Restructuring prohibited.* Restructuring under §1.401(a)(4)-9(c) may not be used to demonstrate compliance with the requirements of section 401(k). See §1.401(a)(4)-9(c)(3)(ii).

(v) *Modifications to section 410(b) rules—(A) Certain disaggregation rules not applicable.* The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)-7(c)(1) and ESOP and non-ESOP portions of a plan set forth in §1.410(b)-7(c)(2) shall not apply for purposes of this section and §§1.401(k)-2 through 1.401(k)-6. Accordingly, notwithstanding §1.410(b)-7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of section 414(l), as described in §1.410(b)-7(b)) are permitted to be aggregated for these purposes.

(B) *Permissive aggregation of collective bargaining units.* Notwithstanding the general rule under section 410(b) and §1.410(b)-7(c) that a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in the collective bargaining unit is treated as comprising separate plans, an employer can treat two or more separate collective bargaining units as a single collective bargaining unit for purposes of this section and §§1.401(k)-2 through 1.401(k)-6, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories (e.g., employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in

any collective bargaining unit), the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as comprising only two separate plans, one benefiting all employees who are included in a collective bargaining unit and another benefiting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of §1.410(b)–6(d)(2).

(C) *Multiemployer plans.* Notwithstanding §1.410(b)–7(c)(4)(ii)(C), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of §1.413–1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefiting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (b)(4)(v)(B) of this section (including the permissive aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and that appropriate fiduciary obligations are taken into account. The noncollectively bargained

portion of the plan is treated as maintained by one or more employers, depending on whether the noncollectively bargaining unit employees who benefit under the plan are employed by one or more employers.

(vi) *Examples.* The following examples illustrate the application of this paragraph (b)(4):

*Example 1.* (i) Employer A maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. For purposes of applying section 410(b), Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans).

(ii) Under these facts, the requirements of this section and §§1.401(k)–2 through 1.401(k)–6 must be applied on an employer-wide rather than a qualified separate line of business basis.

*Example 2.* (i) Employer B maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer B are eligible to participate. For purposes of applying section 410(b), the plan treats the cash or deferred arrangement as two separate plans, one for the employees who have completed the minimum age and service eligibility conditions under section 410(a)(1) and the other for employees who have not completed the conditions. The plan provides that it will satisfy the section 401(k) safe harbor requirement of §1.401(k)–3 with respect to the employees who have met the minimum age and service conditions and that it will meet the ADP test requirements of §1.401(k)–2 with respect to the employees who have not met the minimum age and service conditions.

(ii) Under these facts, the cash or deferred arrangement must be disaggregated on a consistent basis with the disaggregation of Plan W. Thus, the requirements of §1.401(k)–2 must be applied by comparing the ADP for eligible HCEs who have not completed the minimum age and service conditions with the ADP for eligible NHCEs for the applicable year who have not completed the minimum age and service conditions.

*Example 3.* (i) Employer C maintains Plan X, a stock-bonus plan including an ESOP. The plan also

includes a cash or deferred arrangement for participants in the ESOP and non-ESOP portions of the plan.

(ii) Pursuant to paragraph (b)(4)(v)(A) of this section the ESOP and non-ESOP portions of the stock-bonus plan are a single cash or deferred arrangement for purposes of this section and §§1.401(k)–2 through 1.401(k)–6. However, as provided in paragraph (a)(4)(iv)(C) of this section, the ESOP and non-ESOP portions of the plan are still treated as separate plans for purposes of satisfying the requirements of section 410(b).

(c) *Nonforfeitable requirements—(1) General rule.* A cash or deferred arrangement satisfies this paragraph (c) only if the amount attributable to an employee’s elective contributions are immediately nonforfeitable, within the meaning of paragraph (c)(2) of this section, are disregarded for purposes of applying section 411(a)(2) to other contributions or benefits, and the contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Definition of immediately nonforfeitable.* An amount is immediately nonforfeitable if it is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. An amount that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(3) *Example.* The following example illustrates the application of this paragraph (c):

*Example.* (i) Employees B and C are covered by Employer Y’s stock bonus plan, which includes a cash or deferred arrangement. All employees participating in the plan have a nonforfeitable right to a percentage of their account balance derived from all contributions (including elective contributions) as shown in the following table:

| Years of service | Nonforfeitable percentage |
|------------------|---------------------------|
| Less than 1      | 0%                        |
| 1                | 20%                       |
| 2                | 40%                       |
| 3                | 60%                       |
| 4                | 80%                       |
| 5 or more        | 100%                      |

(ii) The cash or deferred arrangement does not satisfy paragraph (c) of this section because elective

contributions are not immediately nonforfeitable.

Thus, the cash or deferred arrangement is a nonqualified cash or deferred arrangement.

(d) *Distribution limitation*—(1) *General rule.* A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the additional requirements of paragraphs (d)(2) through (5) of this section (to the extent applicable)—

(i) The employee's death, disability, or severance from employment;

(ii) In the case of a profit-sharing, stock bonus or rural cooperative plan, the employee's attainment of age 59½, or the employee's hardship; or

(iii) The termination of the plan.

(2) *Rules applicable to distributions upon severance from employment.* An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee.

(3) *Rules applicable to hardship distributions*—(i) *Distribution must be on account of hardship.* A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section if and only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

(ii) *Limit on maximum distributable amount*—(A) *General rule.* A distribution on account of hardship must be limited to the maximum distributable amount. The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution,

reduced by the amount of previous distributions of elective contributions. Thus, the maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered under paragraph (d)(3)(ii)(B) of this section.

(B) *Grandfathered amounts.* If the plan so provides, the maximum distributable amount may be increased for amounts credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or in the case of a collectively bargained plan, the earlier of—

(1) The later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986, terminates (determined without regard to any extension thereof after February 28, 1986); or

(2) January 1, 1991, and consisting of—

(i) Income allocable to elective contributions;

(ii) Qualified nonelective contributions and allocable income; and

(iii) Qualified matching contributions and allocable income.

(iii) *Immediate and heavy financial need*—(A) *In general.* Whether an employee has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) *Deemed immediate and heavy financial need.* A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for—

(1) Expenses for (or necessary to obtain) medical care that would be deductible under section 213(a) (determined without regard to whether the expenses exceed 7.5% of adjusted gross income);

(2) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(3) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(b)(1), (b)(2) and (d)(1)(B));

(4) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence;

(5) Payments for burial or funeral expenses for the employee's deceased parent, spouse, children or dependents (as defined in section 152, and, for taxable years beginning on or after January 1, 2005, without regard to section 152(d)(1)(B)); or

(6) Expenses for the repair of damage to the employee's principal residence that would qualify for the casualty deduction under section 165 (determined without regard to whether the loss exceeds 10% of adjusted gross income).

(iv) *Distribution necessary to satisfy financial need*—(A) *Distribution may not exceed amount of need.* A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need. For this purpose, the amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(B) *No alternative means available.* A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all the relevant facts and circumstances. For purposes of this paragraph (d)(3)(iv), the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of

the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee.

(C) *Employer reliance on employee representation.* For purposes of paragraph (d)(3)(iv)(B) of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's representation (made in writing or such other form as may be prescribed by the Commissioner), unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved—

(1) Through reimbursement or compensation by insurance or otherwise;

(2) By liquidation of the employee's assets;

(3) By cessation of elective contributions or employee contributions under the plan;

(4) By other currently available distributions (including distribution of ESOP dividends under section 404(k) and nontaxable (at the time of the loan) loans, under plans maintained by the employer or by any other employer; or

(5) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) *Employee need not take counterproductive actions.* For purposes of this paragraph (d)(3)(iv), a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) of this section if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(E) *Distribution deemed necessary to satisfy immediate and heavy financial need.* A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied—

(1) The employee has obtained all other currently available distributions (including distribution of ESOP dividends under section 404(k), but not hardship distributions) and nontaxable (at the time of the loan)

loans, under the plan and all other plans maintained by the employer; and

(2) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) *Definition of other plans.* For purposes of paragraph (d)(3)(iv)(C)(4) and (E)(1) of this section, the phrase *plans maintained by the employer* means all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan (including one that is part of a cafeteria plan). In addition, for purposes of paragraph (d)(3)(iv)(E)(2) of this section, the phrase *plans maintained by the employer* also includes a stock option, stock purchase, or similar plan maintained by the employer. See §1.401(k)-6 for the continued treatment of suspended employees as eligible employees.

(v) *Commissioner may expand standards.* The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter), expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.

(4) *Rules applicable to distributions upon plan termination—(i) No alternative defined contribution plan.* A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains an alternative defined contribution plan. For purposes of the preceding sentence, the definition of the term "employer" contained in §1.401(k)-6 is applied as of the date of plan termination, and a plan is an alternative defined contribution plan only if it is a defined contribution plan that exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if

at all times during the 24-month period beginning 12 months before the date of plan termination, fewer than 2% of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement as of the date of plan termination are eligible under the other defined contribution plan, the other plan is not an alternative defined contribution plan. In addition, a defined contribution plan is not treated as an alternative defined contribution plan if it is an employee stock ownership plan as defined in section 4975(e)(7) or 409(a), a simplified employee pension as defined in section 408(k), a SIMPLE IRA plan as defined in section 408(p), a plan or contract that satisfies the requirements of section 403(b), or a plan that is described in section 457(b) or (f).

(ii) *Lump sum requirement for certain distributions.* A distribution may be made under paragraph (d)(1)(iii) of this section only if it is a lump sum distribution. The term lump sum distribution has the meaning provided in section 402(e)(4)(D) (without regard to section 402(e)(4)(D)(i)(I), (II), (III) and (IV)). In addition, a lump sum distribution includes a distribution of an annuity contract from a trust that is part of a plan described in section 401(a) and which is exempt from tax under section 501(a) or an annuity plan described in 403(a).

(5) *Rules applicable to all distributions—(i) Exclusive distribution rules.* Amounts attributable to elective contributions may not be distributed on account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in §1.402(g)-1(e)(2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d). Pursuant to section 401(k)(8), the prohibition on distributions set forth in this section does not apply to a distribution of excess contributions under §1.401(k)-2(b).

(ii) *Deemed distributions.* The cost of life insurance (determined under section 72) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph (d). The making of a loan is not treated as a distribution, even if the loan

is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) *ESOP dividend distributions.* A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) *Limitations apply after transfer.* The limitations of this paragraph (d) generally continue to apply to amounts attributable to elective contributions (including QNECs and qualified matching contributions taken into account for the ADP test under §1.401(k)-2(a)(6)) that are transferred to another qualified plan of the same or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). In addition, a cash or deferred arrangement fails to satisfy the limitations of this paragraph (d) if it transfers amounts to a plan that does not provide that the transferred amounts may not be distributed before the times specified in this paragraph (d). The transferor plan does not fail to comply with the preceding sentence if it reasonably concludes that the transferee plan provides that the transferred amounts may not be distributed before the times specified in this paragraph (d). What constitutes a basis for a reasonable conclusion is determined under standards comparable to those under the rules related to acceptance of rollover distributions. See §1.401(a)(31)-1, A-14. The limitations of this paragraph (d) cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in §1.411(d)-4, Q&A-3(b)(1). The limitations of this paragraph (d) also do not apply to amounts that have been paid in a direct rollover to the plan after being distributed by another plan.

(6) *Examples.* The following examples illustrate the application of this paragraph (d):

*Example 1.* Employer M maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the cash or deferred arrangement is a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

*Example 2.* (i) Employer N maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement. Plan W provides for distributions upon a participant's severance from employment, death or disability. All employees of Employer N and its wholly owned subsidiary, Employer O, are eligible to participate in Plan W. Employer N agrees to sell all issued and outstanding shares of Employer O to an unrelated entity, Employer T, effective on December 31, 2006. Following the transaction, Employer O will be a wholly owned subsidiary of Employer T. Additionally, individuals who are employed by Employer O on the effective date of the sale continue to be employed by Employer O following the sale. Following the transaction, all employees of Employer O will cease to participate in Plan W and will become eligible to participate in the cash or deferred arrangement maintained by Employer T, Plan X. No assets will be transferred from Plan W to Plan X, except in the case of a direct rollover within the meaning of section 401(a)(31).

(ii) Employer O ceases to be a member of Employer N's controlled group as a result of the sale. Therefore, employees of Employer O who participated in Plan W will have a severance from employment and are eligible to receive a distribution from Plan W.

*Example 3.* (i) Employer Q maintains Plan Y, a profit-sharing plan that includes a cash or deferred arrangement. Plan Y, the only plan maintained by Employer Q, does not provide for loans. However, Plan Y provides that elective contributions under the arrangement may be distributed to an eligible employee on account of hardship using the deemed immediate and heavy financial need provisions of paragraph (d)(3)(iii)(B) of this section and provisions regarding distributions necessary to satisfy financial need of paragraphs (d)(3)(iv)(A) through (D) of this section. Employee A is an eligible employee in Plan Y with an account balance of \$50,000 attributable to elective contributions made by Employee A. The total amount of elective contributions made by Employee A, who has not previously received a distribution from Plan Y, is \$20,000. Employee A requests a \$15,000 hardship distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent. At the time of the distribution request, the sole asset of Employee A (that is reasonably available to Employee A within the meaning of paragraph (d)(3)(iv)(B) of this section) is a savings account with an available balance of \$10,000.

(ii) A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-

secondary education and room and board expenses for Employee A's dependent is deemed to be on account of an immediate and heavy financial need of Employee A.

(iii) A distribution is treated as necessary to satisfy Employee A's immediate and heavy financial need to the extent the need may not be relieved from other resources reasonably available to Employee A. Under paragraph (d)(3)(iv)(B) of this section, Employee A's \$10,000 savings account is a resource that is reasonably available to the employee and must be taken into account in determining the amount necessary to satisfy Employee A's immediate and heavy financial need. Thus, Employee A may receive a distribution of only \$5,000 of his elective contributions on account of this hardship, plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

*Example 4.* (i) The facts are the same as in *Example 3.* Employee B, another employee of Employer Q has an account balance of \$25,000, attributable to Employee B's elective contributions. The total amount of elective contributions made by Employee B, who has not previously received a distribution from Plan Y, is \$15,000. Employee B requests a \$10,000 distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his child. Employee B makes a written representation (with respect to which Employer Q has no actual knowledge to the contrary) that the need cannot reasonably be relieved:

A) Through reimbursement or compensation by insurance or otherwise;

B) By liquidation of the employee's assets;

C) By cessation of elective contributions or employee contributions under the plan;

D) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or

E) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee B's child is deemed to be on account of an Employee B's immediate and heavy financial need. In addition, because Employer Q can rely on Employee B's written representation, the distribution is considered necessary to satisfy Employee B's immediate and heavy financial need. Therefore, Employee B may receive a \$10,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

*Example 5.* (i) The facts are the same as in *Example 3*, except Plan Y provides for hardship distributions using the safe harbor rule of paragraph (d)(3)(iv)(E) of this section. Accordingly, Plan Y provides for a 6 month suspension of an eligible employee's elective contributions and employee contributions to the plan after the receipt of a hardship distribution by such eligible employee.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependent is deemed to be



on account of an Employee A's immediate and heavy financial need. In addition, because Employee A is not eligible for any other distribution or loan from Plan Y and Plan Y suspends Employee A's elective contributions and employee contributions following receipt of the hardship distribution, the distribution will be deemed necessary to satisfy Employee A's immediate and heavy financial need (and Employee A is not required to first liquidate his savings account). Therefore, Employee A may receive a \$15,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

*Example 6.* Employer R maintains a pre-ERISA money purchase pension plan that includes a cash or deferred arrangement that is not a rural cooperative plan. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a permissible distribution event only in a profit-sharing, stock bonus or rural cooperative plan. Since elective contributions under the arrangement may be distributed before a permissible distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a money purchase pension plan may not provide for payment of benefits upon hardship. See §1.401-1(b)(1)(i).

(e) *Additional requirements for qualified cash or deferred arrangements—(1) Qualified plan requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. However, except as expressly permitted under section 401(m), 410(b)(2)(A)(ii) or 416(c)(2)(A), elective contributions and matching contributions taken into account under §1.401(k)-2(a) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the contributions are made) satisfy the requirements of section 401(a).

(2) *Election requirements—(i) Cash must be available.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided

the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement, but would be treated as a matching contribution. This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(ii) *Frequency of elections.* A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

(3) *Separate accounting requirement—(i) General rule.* A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless contributions and withdrawals are attributed to the separate accounts and gains, losses, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section. The separate accounting requirement of this paragraph (e)(3)(i) applies at the time the elective contribution is contributed to the plan and continues to

apply until the contribution is distributed under the plan.

(ii) *Satisfaction of separate accounting requirement.* The requirements of paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a qualified cash or deferred arrangement (and, if applicable, under another plan to which QNECs and QMACs are made) are subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments—(i) General rule.* A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted after May 6, 1986, by a State or local government or political subdivision thereof, or any agency or instrumentality thereof (a governmental unit). For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(ii) *Rural cooperative plans and Indian tribal governments.* This paragraph (e)(4) does not apply to a rural cooperative plan or to a plan of an employer which is an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under Federal, State or tribal law which is owned in whole or in part by any of the entities in this paragraph (e)(4)(ii).

(iii) *Adoption after May 6, 1986.* A cash or deferred arrangement is treated as adopted after May 6, 1986, with respect to all employees of any employer that adopts the arrangement after such date.

(iv) *Adoption before May 7, 1986.* If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date. If an employer adopted an arrangement prior to such date, all employees of the employer may participate in the arrangement.

(5) *One-year eligibility requirement.* A cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service with the employer maintaining the plan extend-

ing beyond the period permitted under section 410(a)(1) (determined without regard to section 410(a)(1)(B)(i)) to be eligible to make a cash or deferred election under the arrangement.

(6) *Other benefits not contingent upon elective contributions*—(i) *General rule.* A cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to —

(A) Any matching contribution (as defined in §1.401(m)–1(a)(2)) made by reason of such an election;

(B) Any benefit, right or feature (such as a plan loan) that requires, or results in, an amount to be withheld from an employee's pay (e.g., to pay for the benefit or to repay the loan), to the extent the cash or deferred arrangement restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes);

(C) Any reduction in the employer's top-heavy contributions under section 416(c)(2) because of matching contributions that resulted from the elective contributions; or

(D) Any benefit that is provided at the employee's election under a plan described in section 125(d) in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) *Definition of other benefits.* For purposes of this paragraph (e)(6), other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary, bonuses or other cash remuneration (other than the amount that would be contributed under the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective con-

tributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be made. Additionally, benefits under any other plan or arrangement (whether or not qualified) are not contingent upon an employee's electing to make or not to make elective contributions under a cash or deferred arrangement merely because the elective contributions are or are not taken into account as compensation under the other plan or arrangement for purposes of determining benefits.

(iii) *Effect of certain statutory limits.* Any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 (88 Stat. 829), Public Law 93–406, that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(iv) *Nonqualified deferred compensation.* Except as otherwise provided in paragraph (e)(6)(iii) of this section, participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions.

(v) *Plan loans and distributions.* A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is based on the amount of the employee's account balance.

(vi) *Examples.* The following examples illustrate the application of this paragraph (e)(6):

*Example 1.* Employer T maintains a cash or deferred arrangement for all of its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the nonqualified deferred compensation plan, R and C are eligible to participate only if they do not make elective contributions under the cash or deferred arrangement. Participation in the nonqualified plan is a contingent benefit

for purposes of this paragraph (e)(6), because R's and C's participation is conditioned on their electing not to make elective contributions under the cash or deferred arrangement.

*Example 2.* Employer T maintains a cash or deferred arrangement for all its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the arrangements, Employees R and C may defer a maximum of 10% of their compensation, and may allocate their deferral between the cash or deferred arrangement and the nonqualified deferred compensation plan in any way they choose (subject to the overall 10% maximum). Because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6).

(7) *Plan provision requirement.* A plan that includes a cash or deferred arrangement satisfies this paragraph (e) only if it provides that the nondiscrimination requirements of section 401(k) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1)(ii) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3), as described in paragraph (b)(1)(ii)(A) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(k)(12), as described in paragraph (b)(1)(ii)(B) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (e)(7), a plan may incorporate by reference the provisions of section 401(k)(3) and §1.401(k)–2 if that is the nondiscrimination test being applied. The Commissioner may, in guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), specify the options that will apply under the plan if the nondiscrimination test

is incorporated by reference in accordance with the preceding sentence.

(f) *Special rules for designated Roth contributions.* [Reserved].

(g) *Effective dates—(1) General rule.* Except as otherwise provided in this paragraph (g), this section and §§1.401(k)–2 through 1.401(k)–6 apply to plan years that begin on or after January 1, 2006.

(2) *Early implementation permitted.* A plan is permitted to apply the rules of this section and §§1.401(k)–2 through 1.401(k)–6 to any plan year that ends after December 29, 2004, provided the plan applies all the rules of this section and §§1.401(k)–2 through 1.401(k)–6 and all the rules of §§1.401(m)–1 through 1.401(m)–5, to the extent applicable, for that plan year and all subsequent plan years.

(3) *Collectively bargained plans.* In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers in effect on the date described in paragraph (g)(1) of this section, the provisions of this section and §§1.401(k)–2 through 1.401(k)–6 apply to the later of the first plan year beginning after the termination of the last such agreement or the first plan year described in paragraph (g)(1) of this section.

(4) *Applicability of prior regulations.* For any plan year before a plan applies this section and §§1.401(k)–2 through 1.401(k)–6 (either the first plan year beginning on or after January 1, 2006, or such earlier year, as provided in paragraph (g)(2) of this section), §1.401(k)–1 (as it appeared in the April 1, 2004, edition of 26 CFR part 1) applies to the plan to the extent that section, as it so appears, reflects the statutory provisions of section 401(k) as in effect for the relevant year.

#### *§1.401(k)–2 ADP test.*

(a) *Actual deferral percentage (ADP) test—(1) In general—(i) ADP test formula.* A cash or deferred arrangement satisfies the ADP test for a plan year only if—

(A) The ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ADP for the eligible HCEs for the plan year over the ADP

for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees.* If, for the applicable year for determining the ADP of the NHCEs for a plan year, there are no eligible NHCEs (*i.e.*, all of the eligible employees under the cash or deferred arrangement for the applicable year are HCEs), the arrangement is deemed to satisfy the ADP test for the plan year.

(iii) *Special rule for early participation.* If a cash or deferred arrangement provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the cash or deferred arrangement meets the requirements of section 410(b)(1), then in determining whether the arrangement meets the requirements under paragraph (a)(1) of this section, either—

(A) Pursuant to section 401(k)(3)(F), the ADP test is performed under the plan (determined without regard to disaggregation under §1.410(b)–7(c)(3)), using the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(k)–1(b)(4), the plan is disaggregated into separate plans and the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ADP—(i) General rule.* The ADP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ADRs of the eligible employees in that group for that year. The ADP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method.* The ADP test is applied using the prior year testing method or the current year testing method. Under the prior year

testing method, the applicable year for determining the ADP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ADP test is being performed. Under the prior year testing method, the ADP for the eligible NHCEs is determined using the ADRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ADP test is being calculated. Under the current year testing method, the applicable year for determining the ADP for the eligible NHCEs is the same plan year as the plan year for which the ADP test is being performed. Under either method, the ADP for eligible HCEs is the average of the ADRs of the eligible HCEs for the plan year for which the ADP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ADR—(i) General rule.* The ADR of an eligible employee for a plan year or applicable year is the sum of the employee's elective contributions taken into account with respect to such employee for the year, determined under the rules of paragraphs (a)(4) and (5) of this section, and the qualified nonelective contributions and qualified matching contributions taken into account with respect to such employee under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ADR is calculated to the nearest hundredth of a percentage point. If no elective contributions, qualified nonelective contributions, or qualified matching contributions are taken into account under this section with respect to an eligible employee for the year, the ADR of the employee is zero.

(ii) *ADR of HCEs eligible under more than one arrangement—(A) General rule.* Pursuant to section 401(k)(3)(A), the ADR of an HCE who is an eligible employee in more than one cash or deferred arrangement of the same employer is calculated by treating all contributions with respect to such HCE under any such arrangement as being made under the cash or deferred arrangement being tested. Thus, the ADR for such an HCE is calculated by accumulating all contributions under any cash or deferred arrangement (other than a cash or deferred arrangement described

in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the cash or deferred arrangement under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ADR for the plan year of that plan for an HCE who participates in multiple cash or deferred arrangements of the same employer is the sum of all contributions during such 12-month period that would be taken into account with respect to the HCE under all such arrangements in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(k)-3.

(B) *Plans not permitted to be aggregated.* Cash or deferred arrangements

under plans that are not permitted to be aggregated under §1.401(k)-1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(k)-1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)-7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Examples.* The following examples illustrate the application of this paragraph (a)(3):

*Example 1.* (i) Employee A, an HCE with compensation of \$120,000, is eligible to make elective contributions under Plan S and Plan T, two profit-sharing plans maintained by Employer H with calendar year plan years, each of which includes a cash or deferred arrangement. During the current plan year, Employee A makes elective contributions of \$6,000 to Plan S and \$4,000 to Plan T.

(ii) Under each plan, the ADR for Employee A is determined by dividing Employee A's total elective contributions under both arrangements by Employee A's compensation taken into account under the plan

for the year. Therefore, Employee A's ADR under each plan is 8.33% (\$10,000/\$120,000).

*Example 2.* (i) The facts are the same as in *Example 1*, except that Plan T defines compensation (for deferral and testing purposes) to exclude all bonuses paid to an employee. Plan S defines compensation (for deferral and testing purposes) to include bonuses paid to an employee. During the current year, Employee A's compensation included a \$10,000 bonus. Therefore, Employee A's compensation under Plan T is \$110,000 and Employee A's compensation under Plan S is \$120,000.

(ii) Employee A's ADR under Plan T is 9.09% (\$10,000/\$110,000) and under Plan S, Employee A's ADR is 8.33% (\$10,000/\$120,000).

*Example 3.* (i) Employer J sponsors two profit-sharing plans, Plan U and Plan V, each of which includes a cash or deferred arrangement. Plan U's plan year begins on July 1 and ends on June 30. Plan V has a calendar year plan year. Compensation under both plans is limited to the participant's compensation during the period of participation. Employee B is an HCE who participates in both plans. Employee B's monthly compensation and elective contributions to each plan for the 2005 and 2006 calendar years are as follows:

| Calendar year | Monthly Compensation | Monthly Elective Contribution to Plan U | Monthly Elective Contribution to Plan V |
|---------------|----------------------|---|---|
| 2005          | \$10,000             | \$500                                   | \$400                                   |
| 2006          | \$11,500             | \$700                                   | \$550                                   |

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and Plan V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is  $((\$900 \times 6) + (\$1,250 \times 6)) / ((\$10,000 \times 6) + (\$11,500 \times 6))$ , or 10%.

(iii) Under Plan V, Employee B's ADR for the plan year ended December 31, 2005, is equal to total elective contributions under Plan U and V for the plan year ending December 31, 2005, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan V for the plan year ending December 31, 2005, is  $(\$10,800 / \$120,000)$ , or 9%.

*Example 4.* (i) The facts are the same as *Example 3*, except that Employee B first becomes eligible to participate in Plan U on January 1, 2006.

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is  $((\$400 \times 6) + (\$1,250 \times 6)) / ((\$10,000 \times 6) + (\$11,500 \times 6))$ , or 7.67%.

(4) *Elective contributions taken into account under the ADP test—(i) General rule.* An elective contribution is taken into account in determining the ADR for an eligible employee for a plan year or ap-

plicable year only if each of the following requirements is satisfied—

(A) The elective contribution is allocated to the eligible employee's account under the plan as of a date within that year. For purposes of this rule, an elective contribution is considered allocated as of a date within a year only if—

(1) The allocation is not contingent on the employee's participation in the plan or performance of services on any date subsequent to that date; and

(2) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year to which the contribution relates.

(B) The elective contribution relates to compensation that either—

(1) Would have been received by the employee in the year but for the employee's election to defer under the arrangement; or

(2) Is attributable to services performed by the employee in the year and, but for the employee's election to defer, would have been received by the employee within 2½ months after the close of the year, but only if the plan provides for elective con-

tributions that relate to compensation that would have been received after the close of a year to be allocated to such prior year rather than the year in which the compensation would have been received.

(ii) *Elective contributions for partners and self-employed individuals.* For purposes of this paragraph (a)(4), a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year and a sole proprietor's compensation is treated as received on the last day of the individual's taxable year. Thus, an elective contribution made on behalf of a partner or sole proprietor is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (a)(4)(i) of this section are met.

(iii) *Elective contributions for HCEs.* Elective contributions of an HCE must include any excess deferrals, as described in §1.402(g)-1(a), even if those excess deferrals are distributed, pursuant to §1.402(g)-1(e).

(5) *Elective contributions not taken into account under the ADP test—(i) General rule.* Elective contributions that do not sat-

isfy the requirements of paragraph (a)(4)(i) of this section may not be taken into account in determining the ADR of an eligible employee for the plan year or applicable year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions must satisfy the requirements of section 401(a)(4) (without regard to the ADP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Elective contributions for NHCEs.* Elective contributions of an NHCE shall not include any excess deferrals, as described in §1.402(g)–1(a), to the extent the excess deferrals are prohibited under section 401(a)(30). However, to the extent that the excess deferrals are not prohibited under section 401(a)(30), they are included in elective contributions even if distributed pursuant to §1.402(g)–1(e).

(iii) *Elective contributions treated as catch-up contributions.* Elective contributions that are treated as catch-up contributions under section 414(v) because they exceed a statutory limit or employer-provided limit (within the meaning of §1.414(v)–1(b)(1)) are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions were made, or for any other plan year.

(iv) *Elective contributions used to satisfy the ACP test.* Except to the extent necessary to demonstrate satisfaction of the requirement of §1.401(m)–2(a)(6)(ii), elective contributions taken into account for the ACP test under §1.401(m)–2(a)(6) are not taken into account under paragraph (a)(4) of this section.

(v) *Additional elective contributions pursuant to section 414(u).* Additional elective contributions made pursuant to section 414(u) by reason of an eligible employee's qualified military service are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions are made, or for any other plan year.

(6) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the ADP test.* Qualified nonelective contributions and qualified matching contributions may

be taken into account in determining the ADR for an eligible employee for a plan year or applicable year but only to the extent the contributions satisfy the following requirements—

(i) *Timing of allocation.* The qualified nonelective contribution or qualified matching contribution is allocated to the employee's account as of a date within that year within the meaning of paragraph (a)(4)(i)(A) of this section. Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP for the eligible NHCEs for the applicable year, a qualified nonelective contribution or qualified matching contribution must be contributed no later than the end of the 12-month period immediately following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Requirement that amount satisfy section 401(a)(4).* The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). The amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, then the

determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iii) *Aggregation must be permitted.* The plan that contains the cash or deferred arrangement and the plan or plans to which the qualified nonelective contributions or qualified matching contributions are made, are plans that would be permitted to be aggregated under §1.401(k)–1(b)(4). If the plan year of the plan that contains the cash or deferred arrangement is changed to satisfy the requirement under §1.410(b)–7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if such qualified nonelective contributions and qualified matching contributions could have been taken into account under an ADP test for a plan with the same short plan year.

(iv) *Disproportionate contributions not taken into account—(A) General rule.* Qualified nonelective contributions cannot be taken into account for a plan year for an NHCE to the extent such contributions exceed the product of that NHCE's compensation and the greater of 5% or two times the plan's representative contribution rate. Any qualified nonelective contribution taken into account under an ACP test under §1.401(m)–2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(m)–2(a)(6)(v)(B)), is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate under paragraph (a)(6)(iv)(B) of this section).

(B) *Definition of representative contribution rate.* For purposes of this paragraph (a)(6)(iv), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the plan

year and who is employed by the employer on the last day of the plan year).

(C) *Definition of applicable contribution rate.* For purposes of this paragraph (a)(6)(iv), the applicable contribution rate for an eligible NHCE is the sum of the qualified matching contributions taken into account under this paragraph (a)(6) for the eligible NHCE for the plan year and the qualified nonelective contributions made for the eligible NHCE for the plan year, divided by the eligible NHCE's compensation for the same period.

(D) *Special rule for prevailing wage contributions.* Notwithstanding paragraph (a)(6)(iv)(A) of this section, qualified nonelective contributions that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act (46 Stat. 1494), Public Law 71-798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89-286, or similar legislation can be taken into account for a plan year for an NHCE to the

extent such contributions do not exceed 10 percent of that NHCE's compensation.

(v) *Qualified matching contributions.* Qualified matching contributions satisfy this paragraph (a)(6) only to the extent that such qualified matching contributions are matching contributions that are not precluded from being taken into account under the ACP test for the plan year under the rules of §1.401(m)-2(a)(5)(ii).

(vi) *Contributions only used once.* Qualified nonelective contributions and qualified matching contributions cannot be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ADP test, any ACP test, or the requirements of §1.401(k)-3, 1.401(m)-3 or 1.401(k)-4. Thus, for example, matching contributions that are made pursuant to §1.401(k)-3(c) cannot be taken into account under the ADP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(k)-2(c),

qualified nonelective contributions that are taken into account under the current year testing method for a year may not be taken into account under the prior year testing method for the next year.

(7) *Examples.* The following examples illustrate the application of this paragraph (a):

*Example 1.* (i) Employer X has three employees, A, B, and C. Employer X sponsors a profit-sharing plan (Plan Z) that includes a cash or deferred arrangement. Each year, Employer X determines a bonus attributable to the prior year. Under the cash or deferred arrangement, each eligible employee may elect to receive none, all or any part of the bonus in cash. X contributes the remainder to Plan Z. The portion of the bonus paid in cash, if any, is paid 2 months after the end of the plan year and thus is included in compensation for the following plan year. Employee A is an HCE, while Employees B and C are NHCEs. The plan uses the current year testing method and defines compensation to include elective contributions and bonuses paid during each plan year. In February of 2005, Employer X determined that no bonuses will be paid for 2004. In February of 2006, Employer X provided a bonus for each employee equal to 10% of regular compensation for 2005. For the 2005 plan year, A, B, and C have the following compensation and make the following elections:

| Employee | Compensation | Elective Contribution |
|----------|--------------|-----------------------|
| A        | \$100,000    | \$4,340               |
| B        | 60,000       | 2,860                 |
| C        | 45,000       | 1,250                 |

(ii) For each employee, the ratio of elective contributions to the employee's compensation for the plan year is:

| Employee | Ratio of Elective Contribution to Compensation | ADR   |
|----------|--|-------|
| A        | \$4,340/\$100,000                              | 4.34% |
| B        | 2,860/60,000                                   | 4.77  |
| C        | 1,250/45,000                                   | 2.78  |

(iii) The ADP for the HCEs (Employee A) is 4.34%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 4.34% is less than 4.73% (3.78% multiplied by 1.25), the plan satisfies the ADP test under paragraph (a)(1)(i) of this section.

*Example 2.* (i) The facts are the same as in *Example 1*, except that elective contributions are made pursuant to a salary reduction agreement throughout the plan year, and no bonuses are paid. As provided by section 414(s)(2), Employer X includes elective con-

tributions in compensation. During the year, B and C defer the same amount as in *Example 1*, but A defers \$5,770. Thus, the compensation and elective contributions for A, B, and C are:

| Employee | Compensation | Elective Contributions | ADR   |
|----------|--------------|------------------------|-------|
| A        | \$100,000    | \$5,770                | 5.77% |
| B        | 60,000       | 2,860                  | 4.77  |
| C        | 45,000       | 1,250                  | 2.78  |

(ii) The ADP for the HCEs (Employee A) is 5.77%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 5.77% exceeds 4.73% (3.78% x 1.25), the plan does not satisfy the ADP test under

paragraph (a)(1)(i) of this section. However, because the ADP for the HCEs does not exceed the ADP for the NHCEs by more than 2 percentage points and the ADP for the HCEs does not exceed the ADP for the

NHCEs multiplied by 2 (3.78% x 2 = 7.56%), the plan satisfies the ADP test under paragraph (a)(1)(ii) of this section.

*Example 3.* (i) Employees D through L are eligible employees in Plan T, a profit-sharing plan that contains a cash or deferred arrangement. The plan is a calendar year plan that uses the prior year testing

method. Plan T provides that elective contributions are included in compensation (as provided under section 414(s)(2)). Each eligible employee may elect to defer up to 6% of compensation under the cash or de-

ferred arrangement. Employees D and E are HCEs. The compensation, elective contributions, and ADRs of Employees D and E for the 2006 plan year are shown below:

| Employee | Compensation for 2006 Plan Year | Elective Contributions for 2006 Plan Year | ADR for 2006 Plan Year |
|----------|---------------------------------|---|------------------------|
| D        | \$100,000                       | \$10,000                                  | 10%                    |
| E        | \$95,000                        | \$4,750                                   | 5%                     |

(ii) During the 2005 plan year, Employees F through L were eligible NHCEs. The compensation,

elective contributions and ADRs of Employees F

through L for the 2005 plan year are shown in the following table:

| Employee | Compensation for 2005 Plan Year | Elective Contributions for 2005 Plan Year | ADR for 2005 Plan Year |
|----------|---------------------------------|---|------------------------|
| F        | \$60,000                        | \$3,600                                   | 6%                     |
| G        | \$40,000                        | \$1,600                                   | 4%                     |
| H        | \$30,000                        | \$1,200                                   | 4%                     |
| I        | \$20,000                        | \$600                                     | 3%                     |
| J        | \$20,000                        | \$600                                     | 3%                     |
| K        | \$10,000                        | \$300                                     | 3%                     |
| L        | \$5,000                         | \$150                                     | 3%                     |

(iii) The ADP for 2006 for the HCEs is 7.5%. Because Plan T is using the prior year testing method, the applicable year for determining the NHCE ADP is the prior plan year (*i.e.*, 2005). The NHCE ADP is determined using the ADRs for NHCEs eligible during the prior plan year (without regard to whether they are eligible under the plan during the plan year). The ADP for the NHCEs is 3.71% (the sum of the individual ADRs, 26%, divided by 7 employees). Because 7.5% exceeds 4.64% (3.71% x 1.25), Plan T does not satisfy the ADP test under paragraph (a)(1)(i) of this section. In addition, because the ADP for the HCEs exceeds the ADP for the NHCEs by more than 2 percentage points, Plan T does not satisfy the ADP test

under paragraph (a)(1)(ii) of this section. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

*Example 4.* (i) Plan U is a calendar year profit-sharing plan that contains a cash or deferred arrangement and uses the current year testing method. Plan U provides that elective contributions are included in compensation (as provided under section 414(s)(2)). The following amounts are contributed under Plan U for the 2006 plan year: QNECs equal to 2% of each employee's compensation; Contributions equal to 6% of each employee's compensation that are not

immediately vested under the terms of the plan; 3% of each employee's compensation that the employee may elect to receive as cash or to defer under the plan. Both types of nonelective contributions are made for the HCEs (employees M and N) and the NHCEs (employees O through S) for the plan year and are contributed after the end of the plan year and before the end of the following plan year. In addition, neither type of nonelective contributions is used for any other ADP or ACP test.

(ii) For the 2006 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S are shown in the following table:

| Employee | Compensation | Elective Contributions | Actual Deferral Ratio |
|----------|--------------|------------------------|-----------------------|
| M        | \$100,000    | \$3,000                | 3%                    |
| N        | \$100,000    | \$2,000                | 2%                    |
| O        | \$60,000     | \$1,800                | 3%                    |
| P        | \$40,000     | 0                      | 0                     |
| Q        | \$30,000     | 0                      | 0                     |
| R        | \$5,000      | 0                      | 0                     |
| S        | \$20,000     | 0                      | 0                     |

(iii) The elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section because the ADP for the HCEs, consisting of employees M and N, is 2.5% and the ADP for the NHCEs is 0.6%.

(iv) The 2% QNECs satisfies the timing requirement of paragraph (a)(6)(i) of this section because it is paid within 12-month after the plan year for which allocated. All nonelective contributions also satisfy the

requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section (because all employees receive an 8% nonelective contribution and the nonelective contributions excluding the QNECs is 6% for all employees). In addition, the QNECs are not disproportionate under paragraph (a)(6)(iv) of this section because no QNEC for an NHCE exceeds the product of the plan's applicable contribution rate (2%) and that NHCE's compensation.

(v) Because the rules of paragraph (a)(6) of this section are satisfied, the 2% QNECs may be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section. The 6% nonelective contributions, however, may not be taken into account because they are not QNECs.

(vi) If the 2% QNECs are taken into account, the ADP for the HCEs is 4.5%, and the actual deferral percentage for the NHCEs is 2.6%. Because 4.5% is

not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the cash or deferred arrangement satisfies the ADP test of section 401(k)(3) under paragraph (a)(1)(ii) of this section.

*Example 5.* (i) The facts are the same as *Example 4*, except the plan uses the prior year testing method. In addition, the NHCE ADP for the 2005 plan year (the prior plan year) is 0.8% and no QNECs are contributed for the 2005 plan year during 2005 or 2006.

(ii) In 2007, it is determined that the elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for 2006 because the 2006 ADP for the eligible HCEs, consisting of employees M and N, is 2.5% and the 2005 ADP for the eligible NHCEs is 0.8%. An additional QNEC of 2% of compensation is made for each eligible NHCE in 2007 and allocated for 2005.

(iii) The 2% QNECs that are made in 2007 and allocated for the 2005 plan year do not satisfy the timing requirement of paragraph (a)(6)(i) of this section for the applicable year for the 2005 plan year because they were not contributed before the last day of the 2006 plan year. Accordingly, the 2% QNECs do not satisfy the rules of paragraph (a)(6) of this section and may not be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for the 2006 plan year. The cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

*Example 6.* (i) The facts are the same as *Example 4*, except that the ADP for the HCEs is 4.6% and there is no 6% nonelective contribution under the plan. The employer would like to take into account the 2% QNEC in determining the ADP for the NHCEs but not in determining the ADP for the HCEs.

(ii) The elective contributions alone fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (4.6%) exceeds 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2).

(iii) The 2% QNECs may not be taken into account in determining the ADP of the NHCEs because they fail to satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section. This is because the amount of nonelective contributions, excluding those QNECs that would be taken into account under the ADP test, would be 2% of compensation for the HCEs and 0% for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

*Example 7.* (i) The facts are the same as *Example 6*, except that Employee R receives a QNEC in an amount of \$500 and no QNECs are made on behalf of the other employees.

(ii) If the QNEC could be taken into account under paragraph (a)(6) of this section, the ADP for the NHCEs would be 2.6% and the plan would satisfy the ADP test. The QNEC is disproportionate under paragraph (a)(6)(iv) of this section, and cannot be taken into account under paragraph (a)(6) of this section, to the extent it exceeds the greater of 5% and two times the plan's representative contribution rate (0%), multiplied by Employee R's compensation. The plan's representative contribution rate is 0% because it is the lowest applicable contribution rate among a group of NHCEs that is at least half of all NHCEs, or all the NHCEs who are employed on the last day of the plan year. Therefore, the QNEC may be taken into account under the ADP test only to the extent it does not exceed 5% times Employee R's compensation (or \$250)

and the cash or deferred arrangement fails to satisfy the ADP test and must correct under paragraph (b) of this section.

*Example 8.* (i) The facts are the same as in *Example 4* except that the plan changes from the current year testing method to the prior year testing method for the following plan year (2007 plan year). The ADP for the HCEs for the 2007 plan year is 3.5%.

(ii) The 2% QNECs may not be taken into account in determining the ADP for the NHCEs for the applicable year (2006 plan year) in satisfying the ADP test for the 2007 plan year because they were taken into account in satisfying the ADP test for the 2006 plan year. Accordingly, the NHCE ADP for the applicable year is 0.6%. The elective contributions for the plan year fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (3.5%) exceeds the ADP limit of 1.2% (the greater of 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2)), determined using the applicable year ADP for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

*Example 9.* (i)(A) Employer N maintains Plan X, a profit sharing plan that contains a cash or deferred arrangement and that uses the current year testing method. Plan X provides for employee contributions, elective contributions, and matching contributions. Matching contributions on behalf of NHCEs are qualified matching contributions (QMACs) and are contributed during the 2005 plan year. Matching contributions on behalf of HCEs are not QMACs, because they fail to satisfy the nonforfeitability requirement of §1.401(k)-1(c). The elective contributions and matching contributions with respect to HCEs for the 2005 plan year are shown in the following table:

|                              | Elective Contributions | Total Matching Contributions | Matching contributions that are not QMACs | QMACs |
|------------------------------|------------------------|------------------------------|---|-------|
| Highly compensated employees | 15%                    | 5%                           | 5%  | 0%    |

(B) The elective contributions and matching contributions with respect to the NHCEs for the 2005 plan year are shown in the following table:

|                                 | Elective Contributions | Total Matching Contributions | Matching contributions that are not QMACs | QMACs |
|---------------------------------|------------------------|------------------------------|---|-------|
| Nonhighly compensated employees | 11%                    | 4%                           | 0%  | 4%    |

(ii) The plan fails to satisfy the ADP test of section 401(k)(3)(A) and paragraph (a)(1) of this section because the ADP for HCEs (15%) is more than 125% of the ADP for NHCEs (11%), and more than 2 percentage points greater than 11%. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) provided that they

are not used for any other ADP or ACP test. QMACs equal to 1% of compensation are taken into account for each NHCE in applying the ADP test. After this adjustment, the applicable ADP and ACP (taking into account the provisions of §1.401(m)-2(a)(5)(ii) for the plan year are as follows:

|                                 | Actual Deferral Percentage | Actual Contribution Percentage |
|---------------------------------|----------------------------|--------------------------------|
| HCEs                            | 15%                        | 5%                             |
| Nonhighly compensated employees | 12                         | 3                              |



(iii) The elective contributions and QMACs taken into account for purposes of the ADP test of section 401(k)(3) satisfy the requirements of section 401(k)(3)(A)(ii) under paragraph (a)(1)(ii) of this section because the ADP for HCEs (15%) is not more than the ADP for NHCEs multiplied by 1.25 (12% x 1.25 = 15%).

(b) *Correction of excess contributions*—(1) *Permissible correction methods*—(i) *In general*. A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement, uses any of the following correction methods—

(A) *Qualified nonelective contributions or qualified matching contributions*. The employer makes qualified nonelective contributions or qualified matching contributions that are taken into account under this section and, in combination with other amounts taken into account under paragraph (a) of this section, allow the cash or deferred arrangement to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess contributions distributed*. Excess contributions are distributed in accordance with paragraph (b)(2) of this section.

(C) *Excess contributions recharacterized*. Excess contributions are recharacterized in accordance with paragraph (b)(3) of this section.

(ii) *Combination of correction methods*. A plan may provide for the use of any of the correction methods described in paragraph (b)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. A plan may permit an HCE to elect whether any excess contributions are to be recharacterized or distributed. If the plan uses a combination of correction methods, any contribution made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction methods in paragraph (b)(1)(i)(B) or (C) of this section.

(iii) *Exclusive means of correction*. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than the ones described in paragraphs (b)(1)(i)

and (ii) of this section. Thus, excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5).

(2) *Corrections through distribution*—(i) *General rule*. This paragraph (b)(2) contains the rules for correction of excess contributions through a distribution from the plan. Correction through a distribution generally involves a 4-step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess contributions among HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned excess contributions and allocable income in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions. Paragraph (b)(2)(vii) provides other rules relating to these distributions.

(ii) *Calculation of total amount to be distributed*. The following procedures must be used to determine the total amount of the excess contributions to be distributed—

(A) *Calculate the dollar amount of excess contributions for each HCE*. The amount of excess contributions attributable to a given HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ADR to equal the highest permitted ADR under the plan. To calculate the highest permitted ADR under a plan, the ADR of the HCE with the highest ADR is reduced by the amount required to cause that HCE's ADR to equal the ADR of the HCE with the next highest ADR. If a lesser reduction would enable the arrangement to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction is used in determining the highest permitted ADR.

(B) *Determination of the total amount of excess contributions*. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the arrangement would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess contributions for the plan year.

(C) *Satisfaction of ADP*. A cash or deferred arrangement satisfies this paragraph (b)(2)(ii)(C) if the arrangement would satisfy the requirements of paragraph (a)(1)(ii) of this section if the ADR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess contributions among the HCEs*. The following procedures must be used in apportioning the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section among the HCEs:

(A) *Calculate the dollar amount of excess contributions for each HCE*. The contributions of the HCE with the highest dollar amount of contributions taken into account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of the contributions taken into account under this section for the HCE with the next highest dollar amount of contributions taken into account under this section. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any individual*. For purposes of this paragraph (b)(2)(iii), the amount of contributions taken into account under this section with respect to an HCE who is an eligible employee in more than one plan of an employer is determined by taking into account all contributions otherwise taken into account with respect to such HCE under any plan of the employer during the plan year of the plan being tested as being made under the plan being tested. However, the amount of excess contributions apportioned for a plan year with respect to any HCE must not exceed the amount of contributions actually contributed to the plan for the HCE for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same

employer to which elective contributions are made and whose ADR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount required to be distributed under this paragraph (b)(2)(iii) shall not exceed the contributions actually contributed to the plan and taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs.* The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section has been apportioned.

(iv) *Income allocable to excess contributions—(A) General rule.* The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess contributions are or will be credited with gain or loss for the gap period (*i.e.*, the period after the close of the plan year and prior to the distribution) if the total account were to be distributed, the allocable gain or loss during that period.

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participant's accounts. See § 1.401(a)(4)–1(c)(8). A plan will not fail to use a reasonable method for computing the income allocable to excess contributions merely because the income allocable to excess contributions is determined on a date that is no more than 7 days before the distribution.

(C) *Alternative method of allocating plan year income.* A plan may allocate income to excess contributions for the plan year by multiplying the income for the plan year allocable to the elective contributions and other amounts taken into account under this section (including contributions made for the plan year), by a fraction, the numerator of which is the excess contributions for the employee for the plan year, and the denominator of which is the sum of the—

(I) Account balance attributable to elective contributions and other contributions taken into account under this section as of the beginning of the plan year, and

(2) Any additional amount of such contributions made for the plan year.

(D) *Safe harbor method of allocating gap period income.* A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess contributions for the gap period. Under this safe harbor method, income on excess contributions for the gap period is equal to 10% of the income allocable to excess contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) *Alternative method for allocating plan year and gap period income.* A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to this aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken account under this section for the plan year in determining the fraction that is multiplied by that income.

(v) *Distribution.* Within 12 months after the close of the plan year in which the excess contribution arose, the plan must distribute to each HCE the excess contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section and the allocable income. Except as otherwise provided in this paragraph (b)(2)(v) and paragraph (b)(4)(i) of this section, a distribution of excess contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termina-

tion of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) *Tax treatment of corrective distributions—(A) General rule.* Except as provided in this paragraph (b)(2)(vi), a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the dates the elective contributions would have been received by the employee had the employee originally elected to receive the amounts in cash, treating the excess contributions that are being distributed as the first elective contributions for the plan year. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See also paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year. See also § 1.402(c)–2, A–4 for restrictions on rolling over distributions that are excess contributions.

(B) *Rule for de minimis distributions.* If the total amount of excess contributions, determined under this paragraph (b)(2), and excess aggregate contributions determined under § 1.401(m)–2(b)(2) distributed to a recipient under a plan for any plan year is less than \$100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(vii) *Other rules—(A) No employee or spousal consent required.* A corrective distribution of excess contributions (and income) may be made under the terms of

the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(B) *Treatment of corrective distributions as elective contributions.* Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(C) *No reduction of required minimum distribution.* A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)–5, A–9(b).

(D) *Partial distributions.* Any distribution of less than the entire amount of excess contributions (and allocable income) with respect to any HCE is treated as a *pro rata* distribution of excess contributions and allocable income.

(viii) *Examples.* The following examples illustrate the application of this paragraph (b)(2). For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

*Example 1.* (i) Plan P, a calendar year profit-sharing plan that includes a cash or deferred arrangement, provides for distribution of excess contributions to HCEs to the extent necessary to satisfy the ADP test. For the 2006 plan year, Employee A, an HCE, has elective contributions of \$12,000 and \$200,000 in compensation, for an ADR of 6%, and Employee B, a second HCE, has elective contributions of \$8,960 and compensation of \$128,000, for an ADR of 7%. The ADP for the NHCEs is 3% for the 2006 plan year. Under the ADP test, the ADP of the two HCEs under the plan may not exceed 5% (i.e., 2 percentage points more than the ADP of the NHCEs under the plan). The ADP for the 2 HCEs under the plan is 6.5%. Therefore, there must be a correction of excess contributions for the 2006 plan year.

(ii) The total amount of excess contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the elective contributions of Employee B (the HCE with the highest ADR) are reduced by \$1,280 in order to reduce his ADR to 6% (\$7,680/\$128,000), which is the ADR of Employee A.

(iii) Because the ADP of the HCEs determined after the \$1,280 reduction to Employee B still exceeds 5%, further reductions in elective contributions are necessary in order to reduce the ADP of the HCEs to 5%. The elective contributions of Employee A and Employee B are each reduced by 1% of compensation (\$2,000 and \$1,280 respectively). Because the ADP of the HCEs determined after the reductions equals 5%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess contributions (\$4,560 = \$1,280+\$2,000+\$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of

elective contributions. Therefore, Employee A is apportioned \$3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions).

(v) Because the total amount of excess contributions has not been apportioned, further apportionment is necessary. The balance (\$1,520) of the total amount of excess contributions is apportioned equally among Employee A and Employee B (\$760 to each).

(vi) Therefore, the cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to \$3,800 (\$3,040 + \$760) and allocable income and Employee B receives a corrective distribution of \$760 and allocable income.

*Example 2.* (i) The facts are the same as in *Example 1*, except Employee A's ADR is based on \$3,000 of elective contributions to this plan and \$9,000 of elective contributions to another plan of the employer.

(ii) The total amount of excess contributions (\$4,560 = \$1,280+\$2,000+\$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. The amount of elective contributions for Employee A is \$12,000. Therefore, Employee A is apportioned \$3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions). However, pursuant to paragraph (b)(2)(iii)(B) of this section, no more than the amount actually contributed to the plan may be apportioned to an HCE. Accordingly, no more than \$3,000 may be apportioned to Employee A. Therefore, the remaining \$1,560 must be apportioned to Employee B.

(ii) The cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to \$3,000 (total amount of elective contributions actually contributed to the plan for Employee A) and allocable income and Employee B receives a corrective distribution of \$1,560 and allocable income.

*Example 3.* (i) The facts are the same as in *Example 1*. The plan allocates income on a daily basis. The corrective distributions are made in February 2007. The excess contribution that must be distributed to Employee A as a corrective distribution is \$3,800. This amount must be increased (or decreased) to reflect gains (or losses) allocable to that amount during the 2006 plan year. The plan uses a reasonable method that satisfies paragraph (b)(2)(iv)(B) of this section to determine the gain during the 2006 plan year allocable to the \$3,800 as \$145. Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required would be \$3,945.

(ii) Because the plan allocates income on a daily basis, excess contributions are credited with gain or loss during the gap period. Therefore, the corrective distribution must include income allocable to \$3,945 through the date of distribution. For the period from January 1 through the date of distribution (or if the plan provides 7 days before the date of distribution), the income allocable to \$3,945 is \$105. Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of \$4,050.

*Example 4.* (i) The facts are the same as in *Example 1*. The plan determines plan year income using the alternative method for calculating income provided in paragraph (b)(2)(iv)(C) of this section and using the portion of the participant's account attributable to elective contributions, including elective contributions made for the plan year. The plan uses the safe harbor method provided in paragraph (b)(2)(iv)(D) of this section for allocating gap period income. The corrective distribution is made during the last week of February 2007. At the beginning of the 2006 plan year, \$100,000 of Employee A's plan account represents elective contributions plus attributable earnings. During the 2006 plan year, \$10,000 in elective contributions were contributed to the plan for Employee A. The income allocable to Employee A's account attributable to elective contributions for the 2006 plan year is \$8,000.

(ii) Therefore, the plan year income allocable to the \$3,800 corrective distribution for Employee A is \$266.65 (\$8,000 multiplied by \$3,800 divided by \$110,000). Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required is \$4,066.65. This amount must be increased by the gap period income of \$53.32 (10% multiplied by \$266.65 (2006 plan year income attributable to the excess contribution) multiplied by 2 (number of calendar months since end of 2006 plan year). Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of \$4,119.97.

*Example 5.* (i) The facts are the same as in *Example 4*, except that the plan provides for quarterly valuations based on the account balance at the end of the quarter.

(ii) Because the plan's method for allocating income does not allocate any income to amounts distributed during the quarter, Employee A will not be credited with an allocation of income with respect to the amount distributed. Accordingly, Plan P need not plan adjust the distribution of excess contribution for income during the gap period and thus satisfies paragraph (a)(1) of this section if Employee A receives a corrective distribution of \$4,066.65.

(3) *Recharacterization of excess contributions*—(i) *General rule.* Excess contributions are recharacterized in accordance with this paragraph (b)(3) only if the excess contributions that would have to be distributed under (b)(2) of this section if the plan was correcting through distribution of excess contributions are recharacterized as described in paragraph (b)(3)(ii) of this section, and all of the conditions set forth in paragraph (b)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions.* Recharacterized excess contributions are includible in the employee's gross income as if such amounts were distributed under paragraph (b)(2) of this section. The recharacterized excess contributions are treated as employee contributions for purposes of section 72, sections 401(a)(4), 401(m), §1.401(k)–1(d)

and §1.401(k)-2. This requirement is not treated as satisfied unless the payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by timely providing such Federal tax forms and accompanying instructions and timely taking such other action as is prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) as well as the applicable Federal tax forms and accompanying instructions.

(iii) *Additional rules*—(A) *Time of recharacterization*. Excess contributions may not be recharacterized under this paragraph (b)(3) after 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those HCEs with excess contributions to be recharacterized is notified in accordance with paragraph (b)(3)(ii) of this section.

(B) *Employee contributions must be permitted under plan*. The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the HCE, may not exceed the maximum amount of employee contributions (determined without regard to the ACP test of section 401(m)(2)) permitted under the provisions of the plan as in effect on the first day of the plan year.

(C) *Treatment of recharacterized excess contributions*. Recharacterized excess contributions continue to be treated as employer contributions for all purposes under the Internal Revenue Code (other than those specified in paragraph (b)(3)(ii) of this section), including section 401(a) and sections 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of §1.401(k)-1(c); must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A).

(4) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *Treatment of excess deferrals that reduce excess contributions*. The amount of excess contributions (and allocable income) to be distributed under paragraph (b)(2) of this section or the amount of excess contributions rechar-

acterized under paragraph (b)(3) of this section with respect to an employee for a plan year, is reduced by any amounts previously distributed to the employee from the plan to correct excess deferrals for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals*. Under §1.402(g)-1(e), the amount required to be distributed to correct an excess deferral to an employee for a taxable year is reduced by any excess contributions (and allocable income) previously distributed or excess contributions recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payer or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under §1.402(g)-1(e)(6).

(ii) *Forfeiture of match on distributed excess contributions*. A matching contribution is taken into account under section 401(a)(4) even if the match is with respect to an elective contribution that is distributed or recharacterized under this paragraph (b). This requires that, after correction of excess contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)-4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if elective contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(k)(3), while matching contributions attributable to those elective contributions remain allocated to the HCEs' accounts. Under section 411(a)(3)(G) and §1.411(a)-4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions or excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)-11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions.

(iii) *Permitted forfeiture of QMAC*. Pursuant to section 401(k)(8)(E), a qualified matching contribution is not treated as forfeitable under §1.401(k)-1(c) merely because under the plan it is forfeited in accordance with paragraph (b)(4)(ii) of this section.

(iv) *No requirement for recalculation*. If excess contributions are distributed or recharacterized in accordance with paragraphs (b)(2) and (3) of this section, the cash or deferred arrangement is treated as meeting the nondiscrimination test of section 401(k)(3) regardless of whether the ADP for the HCEs, if recalculated after the distributions or recharacterizations, would satisfy section 401(k)(3).

(v) *Treatment of excess contributions that are catch-up contributions*. A cash or deferred arrangement does not fail to meet the requirements of section 401(k)(3) and paragraph (a)(1) of this section merely because excess contributions that are catch-up contributions because they exceed the ADP limit, as described in §1.414(v)-1(b)(1)(iii), are not corrected in accordance with this paragraph (b).

(5) *Failure to timely correct*—(i) *Failure to correct within 2½ months after end of plan year*. If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess contributions. See section 4979 and §54.4979-1 of this chapter. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (a)(6) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year*. If excess contributions are not corrected within 12 months after the close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(c) *Additional rules for prior year testing method*—(1) *Rules for change in testing method*—(i) *General rule*. A plan is

permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in paragraph (c)(1)(ii) of this section. For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(k)-3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year.

(ii) *Situations permitting a change to the prior year testing method.* The situations described in this paragraph (c)(1)(ii) are:

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

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

(C) A transaction described in section 410(b)(6)(C)(i) and §1.410(b)-2(f) occurs and—

(1) 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

(2) The change from the current year testing method to the prior year testing method occurs within the transition period described in section 410(b)(6)(C)(ii).

(2) *Calculation of ADP under the prior year testing method for the first plan year—*(i) *Plans that are not successor plans.* If, for the first plan year of any plan (other than a successor plan), the plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ADP for eligible NHCEs, or use 3% as the ADP for eligible NHCEs, for applying the ADP test for that first plan year. A plan

(other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting on QNECs under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined.* For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for elective contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)-7(b)) for a plan year if for such plan year the plan is aggregated under §1.401(k)-1(b)(4) with any other plan that provided for elective contributions in the prior year.

(iii) *Successor plans.* A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under a qualified cash or deferred arrangement maintained by the employer in the prior year. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ADP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ADP and ACP test.* Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ADP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ACP test for that year. For example, a plan may use the prior year testing method for the ADP test and the current year testing method for its ACP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use—

(i) The recharacterization method of paragraph (b)(3) of this section to correct excess contributions for a plan year;

(ii) The rules of §1.401(m)-2(a)(6)(ii) to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph (a)(6)(v) of this section to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage changes—*(i) *In general.* A plan that uses the prior year testing method and experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ADP for the NHCEs for the plan year is the weighted average of the ADPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes.* If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ADP for the group of eligible NHCEs for the prior year under the plan is the ADP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions.* The following definitions apply for purposes of this paragraph (c)(4):

(A) *Plan coverage change.* The term *plan coverage change* means a change in the group or groups of eligible employees under a plan on account of—

(1) The establishment or amendment of a plan;

(2) A plan merger or spinoff under section 414(l);

(3) A change in the way plans (within the meaning of §1.410(b)-7(b)) are combined or separated for purposes of §1.401(k)-1(b)(4) (e.g., permissively aggregating plans not previously aggregated under §1.410(b)-7(d), or ceasing to permissively aggregate plans under §1.410(b)-7(d));

(4) A reclassification of a substantial group of employees that has the same effect as amending the plan (e.g., a transfer of a substantial group of employees from one division to another division); or

(5) A combination of any of paragraphs (c)(4)(iii)(A)(1) through (4) of this section.

(B) *Prior year subgroup.* The term *prior year subgroup* means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan maintained by the employer that included a qualified cash or deferred arrangement and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the

first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ADPs for the prior year subgroups.* The term *weighted average of the ADPs for the prior year subgroups* means the sum, for all prior year subgroups, of the adjusted ADPs for the plan year. The term *adjusted ADP with respect to a prior year subgroup* means the ADP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Examples.* The following examples illustrate the application of this paragraph (c)(4):

*Example 1.* (i) Employer B maintains two calendar year plans, Plan O and Plan P, each of which includes a cash or deferred arrangement. The plans were not permissively aggregated under § 1.410(b)-7(d) for the 2005 plan year. Both plans use the prior year testing method. Plan O had 300 eligible employees who were NHCEs for the 2005 plan year, and their ADP for that year was 6%. Sixty of the eligible employees who were NHCEs for the 2005 plan year under Plan O, terminated their employment during that year. Plan P had 100 eligible employees who were NHCEs for 2005, and the ADP for those NHCEs for that plan was 4%. Plan O and Plan P are permissively aggregated under § 1.410(b)-7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of § 1.401(k)-1(b)(4). Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) The Plan O prior year subgroup consists of the 300 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted

ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year)  $\times$  300/400 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year)  $\times$  100/400 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

(v) As provided in paragraph (c)(4)(iii)(B) of this section, the determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether that NHCE terminated employment during the prior year. Thus, the prior ADP for the NHCEs under Plan OP for the 2006 plan year is unaffected by the termination of the 60 NHCEs covered by Plan O during the 2005 plan year.

*Example 2.* (i) The facts are the same as *Example 1*, except that the 60 employees who terminated employment during the 2005 plan are instead spun-off to another plan.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under § 1.410(b)-7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of § 1.401(k)-1(b)(4) and the spin-off of the 60 employees is a plan coverage change. Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) For purposes of determining the prior year subgroups, the employees who would have been eligible employees in the prior year under the plan being tested are determined as if both plan coverage changes had first been effective as of the first day of the prior plan year. The Plan O prior year subgroup consists of the 240 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and would have been eligible under Plan OP for the 2005 plan year if the spin-off had occurred at the beginning of the 2005 plan year and Plan P had been permissively aggregated under § 1.410(b)-7(d) for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated under § 1.410(b)-7(d) for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan O and the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan P. The adjusted ADP for the prior year subgroup consisting of eligible NHCEs under Plan O is 4.23%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year)  $\times$  240/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the prior year subgroup consisting of the eligible NHCEs from Plan P is 1.18%, calculated as follows: 4% (the

ADP for the NHCEs under Plan P for the 2005 plan year)  $\times$  100/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.41% (the sum of adjusted ADPs for the prior year subgroups, 4.23% plus 1.18%).

*Example 3.* (i) The facts are the same as in *Example 1*, except that instead of Plan O and Plan P being permissively aggregated for the 2006 plan year, 200 of the employees eligible under Plan O were spun-off from Plan O and merged into Plan P.

(ii) The spin-off from Plan O and merger to Plan P for the 2006 plan year are plan coverage changes for Plan P. Therefore, the prior year ADP for the NHCEs under Plan P for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan P. There are 2 subgroups under Plan P for the 2006 plan year. The Plan O prior year subgroup consists of the 200 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan P for the 2005 plan year if the spin-off and merger had occurred on the first day of the 2005 plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P for the 2005 plan year.

(iii) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.0%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year)  $\times$  200/300 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1.33%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year)  $\times$  100/300 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan P for the 2006 plan year is 5.33% (the sum of adjusted ADPs for the 2 prior year subgroups, 4.0% plus 1.33%).

(iv) The spin-off from Plan O for the 2006 plan year is a plan coverage change for Plan O. Therefore, the prior year ADP for the NHCEs under Plan O for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan O. In this case, there is only one prior year subgroup under Plan O, the employees who were NHCEs of Employer B for the 2005 plan year and who were eligible for the 2005 plan year under Plan O. Because there is only one prior year subgroup under Plan O, the weighted average of the ADPs for the prior year subgroup under Plan O is equal to the NHCE ADP for the prior year (2005 plan year) under Plan O, or 6%.

*Example 4.* (i) Employer C maintains a calendar year plan, Plan Q, which includes a cash or deferred arrangement that uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 2005, Plan Q had 500 eligible employees who were NHCEs, and the ADP for those NHCEs for 2005 was 2%. Effective January 1, 2006, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 2006. In addition, effective on that same date, Employer C establishes a new calendar year plan, Plan

R, which includes a cash or deferred arrangement that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of paragraph (c)(2)(iii) of this section (because all of the employees were eligible employees under Plan Q in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes within the meaning of paragraph (c)(4)(iii)(A) of this section for Plan Q and Plan R. Accordingly, each plan must determine the NHCE ADP for the 2006 plan year under the rules set forth in paragraph (c)(4) of this section.

(iv) The prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 2005 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 plan year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as if the plan amendment had not occurred.

(v) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 2005 plan year if the plan were established as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

*Example 5.* (i) The facts are the same as in *Example 4*, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any qualified cash or deferred arrangement maintained by Employer C.

(ii) Plan R is a successor plan (because 100 of Plan R's 150 eligible employees were eligible employees under another qualified cash or deferred arrangement maintained by Employer C in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any qualified cash or deferred arrangement of Employer C for the prior plan year, they do not comprise a prior year subgroup. Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

### *§1.401(k)-3 Safe harbor requirements.*

(a) *ADP test safe harbor.* A cash or deferred arrangement satisfies the ADP safe harbor provision of section 401(k)(12) for a plan year if the arrangement satisfies the safe harbor contribution requirement of

paragraph (b) or (c) of this section for the plan year, the notice requirement of paragraph (d) of this section, the plan year requirements of paragraph (e) of this section, and the additional rules of paragraphs (f), (g) and (h) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraph (b) or (c) of this section must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) *Safe harbor nonelective contribution requirement—(1) General rule.* The safe harbor nonelective contribution requirement of this paragraph is satisfied if, under the terms of the plan, the employer is required to make a qualified nonelective contribution on behalf of each eligible NHCE equal to at least 3% of the employee's safe harbor compensation.

(2) *Safe harbor compensation defined.* For purposes of this section, safe harbor compensation means compensation as defined in §1.401(k)-6 (which incorporates the definition of compensation in §1.414(s)-1); provided, however, that the rule in the last sentence of §1.414(s)-1(d)(2)(iii) (which generally permits a definition of compensation to exclude all compensation in excess of a specified dollar amount) does not apply in determining the safe harbor compensation of NHCEs. Thus, for example, the plan may limit the period used to determine safe harbor compensation to the eligible employee's period of participation.

(c) *Safe harbor matching contribution requirement—(1) In general.* The safe harbor matching contribution requirement of this paragraph (c) is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible NHCE in an amount determined under the basic matching formula of section 401(k)(12)(B)(i)(I), as described in paragraph (c)(2) of this section, or under an enhanced matching formula of section 401(k)(12)(B)(i)(II), as described in paragraph (c)(3) of this section.

(2) *Basic matching formula.* Under the basic matching formula, each eligible NHCE receives qualified matching contributions in an amount equal to the sum of—

(i) 100% of the amount of the employee's elective contributions that do not exceed 3% of the employee's safe harbor compensation; and

(ii) 50% of the amount of the employee's elective contributions that exceed 3% of the employee's safe harbor compensation but that do not exceed 5% of the employee's safe harbor compensation.

(3) *Enhanced matching formula.* Under an enhanced matching formula, each eligible NHCE receives a matching contribution under a formula that, at any rate of elective contributions by the employee, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been provided under the basic matching formula of paragraph (c)(2) of this section. In addition, under an enhanced matching formula, the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective contributions may not increase as the amount of an employee's elective contributions increases.

(4) *Limitation on HCE matching contributions.* The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if the ratio of matching contributions made on account of an HCE's elective contributions under the cash or deferred arrangement for a plan year to those elective contributions is greater than the ratio of matching contributions to elective contributions that would apply with respect to any eligible NHCE with elective contributions at the same percentage of safe harbor compensation.

(5) *Use of safe harbor match not precluded by certain plan provisions—(i) Safe harbor matching contributions on employee contributions.* The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions on the same terms as safe harbor matching contributions are made with respect to elective contributions. Alternatively, the safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe har-

bor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions on elective contributions are not affected by the amount of employee contributions.

(ii) *Periodic matching contributions.* The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because the plan provides that safe harbor matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that safe harbor matching contributions with respect to any elective contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(6) *Permissible restrictions on elective contributions by NHCEs*—(i) *General rule.* The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if elective contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (c)(6).

(ii) *Restrictions on election periods.* A plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (d) of this section) to make or change a cash or deferred election for the plan year. For purposes of this paragraph (c)(6)(ii), a 30-day period is deemed to be a reasonable period to make or change a cash or deferred election.

(iii) *Restrictions on amount of elective contributions.* A plan is permitted to limit the amount of elective contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (c)(6)(v) of this section) to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of elective contributions.

However, a plan may require eligible employees to make cash or deferred elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred.* A plan may limit the types of compensation that may be deferred by an eligible employee under a plan, provided that each eligible NHCE is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2). Thus, the definition of compensation from which elective contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code.* A plan may limit the amount of elective contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make elective contributions has been suspended for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E).

(7) *Examples.* The following examples illustrate the safe harbor contribution requirement of this paragraph (c):

*Example 1.* (i) Beginning January 1, 2006, Employer A maintains Plan L covering employees in Divisions D and E, each of which includes HCEs and NHCEs. Plan L contains a cash or deferred arrangement and provides qualified matching contributions equal to 100% of each eligible employee's elective contributions up to 3% of compensation and 50% of the next 2% of compensation. For purposes of the matching contribution formula, safe harbor compensation is defined as all compensation within the meaning of section 415(c)(3) (a definition that satisfies section 414(s)). Also, each employee is permitted to make elective contributions from all safe harbor compensation within the meaning of section 415(c)(3) and may change a cash or deferred election at any time. Plan L limits the amount of an employee's elective contributions for purposes of section 402(g) and section 415, and, in the case of a hardship distribution, suspends an employee's ability to make elective contributions for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E). All contributions under Plan L are nonforfeitable and are subject to the withdrawal restrictions of section 401(k)(2)(B). Plan L provides for no other contributions and Employer A maintains no other plans. Plan L is maintained on a calendar-year basis, and all contributions for a plan year are made within 12 months after the end of the plan year.

(ii) Based on these facts, matching contributions under Plan L are safe harbor matching contributions

because they are qualified matching contributions equal to the basic matching formula. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

*Example 2.* (i) The facts are the same as in *Example 1*, except that instead of providing a basic matching contribution, Plan L provides a qualified matching contribution equal to 100% of each eligible employee's elective contributions up to 4% of safe harbor compensation.

(ii) Plan L's formula is an enhanced matching formula because each eligible NHCE receives safe harbor matching contributions at a rate that, at any rate of elective contributions, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been received under the basic safe harbor matching formula, and the rate of matching contributions does not increase as the rate of an employee's elective contributions increases. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

*Example 3.* (i) The facts are the same as in *Example 2*, except that instead of permitting each employee to make elective contributions from all compensation within the meaning of section 415(c)(3), each employee's elective contributions under Plan L are limited to 15% of the employee's basic compensation. *Basic compensation* is defined under Plan L as compensation within the meaning of section 415(c)(3), but excluding overtime pay.

(ii) The definition of basic compensation under Plan L is a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2).

(iii) Plan L will not fail to satisfy the safe harbor contribution requirement of this paragraph (c) merely because Plan L limits the amount of elective contributions and the types of compensation that may be deferred by eligible employees, provided that each eligible NHCE may make elective contributions equal to at least 4% of the employee's safe harbor compensation.

*Example 4.* (i) The facts are the same as in *Example 1*, except that Plan L provides that only employees employed on the last day of the plan year will receive a safe harbor matching contribution.

(ii) Even if the plan that provides for employee contributions and matching contributions satisfies the minimum coverage requirements of section 410(b)(1) taking into account this last-day requirement, Plan L would not satisfy the safe harbor contribution requirement of this paragraph (c) because safe harbor matching contributions are not made on behalf of all eligible NHCEs who make elective contributions.

(iii) The result would be the same if, instead of providing safe harbor matching contributions, Plan L provides for a 3% safe harbor nonelective contribution that is restricted to eligible employees under the cash or deferred arrangement who are employed on the last day of the plan year.

*Example 5.* (i) The facts are the same as in *Example 1*, except that instead of providing qualified matching contributions under the basic matching formula to employees in both Divisions D and E, employees in Division E are provided qualified matching contributions under the basic matching formula, while safe harbor matching contributions continue to be provided to employees in Division D under the enhanced matching formula described in *Example 2*.



(ii) Even if Plan L satisfies §1.401(a)(4)–4 with respect to each rate of matching contributions available to employees under the plan, the plan would fail to satisfy the safe harbor contribution requirement of this paragraph (c) because the rate of matching contributions with respect to HCEs in Division D at a rate of elective contributions between 3% and 5% would be greater than that with respect to NHCEs in Division E at the same rate of elective contributions. For example, an HCE in Division D who would have a 4% rate of elective contributions would have a rate of matching contributions of 100% while an NHCE in Division E who would have the same rate of elective contributions would have a lower rate of matching contributions.

(d) *Notice requirement*—(1) *General rule*. The notice requirement of this paragraph (d) is satisfied for a plan year if each eligible employee is given notice of the employee’s rights and obligations under the plan and the notice satisfies the content requirement of paragraph (d)(2) of this section and the timing requirement of paragraph (d)(3) of this section. The notice must be in writing or in such other form as may be approved by the Commissioner.

(2) *Content requirement*—(i) *General rule*. The content requirement of this paragraph (d)(2) is satisfied if the notice is—

(A) Sufficiently accurate and comprehensive to inform the employee of the employee’s rights and obligations under the plan; and

(B) Written in a manner calculated to be understood by the average employee eligible to participate in the plan.

(ii) *Minimum content requirement*. Subject to the requirements of paragraph (d)(2)(iii) of this section, a notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes—

(A) The safe harbor matching contribution or safe harbor nonelective contribution formula used under the plan (including a description of the levels of safe harbor matching contributions, if any, available under the plan);

(B) Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;

(C) The plan to which safe harbor contributions will be made (if different than the plan containing the cash or deferred arrangement);

(D) The type and amount of compensation that may be deferred under the plan;

(E) How to make cash or deferred elections, including any administrative requirements that apply to such elections;

(F) The periods available under the plan for making cash or deferred elections;

(G) Withdrawal and vesting provisions applicable to contributions under the plan; and

(H) Information that makes it easy 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 individuals or offices from whom employees can obtain such plan information.

(iii) *References to SPD*. A plan will not fail to satisfy the content requirements of this paragraph (d)(2) merely because, in the case of information described in paragraph (d)(2)(ii)(B) of this section (relating to any other contributions under the plan), paragraph (d)(2)(ii)(C) of this section (relating to the plan to which safe harbor contributions will be made) or paragraph (d)(2)(ii)(D) of this section (relating to the type and amount of compensation that may be deferred under the plan), the notice cross-references the relevant portions of a summary plan description that provides the same information that would be provided in accordance with such paragraphs and that has been provided (or is concurrently provided) to employees.

(3) *Timing requirement*—(i) *General rule*. The timing requirement of this paragraph (d)(3) is satisfied if the notice is provided within a reasonable period before the beginning of the plan year (or, in the year an employee becomes eligible, within a reasonable period before the employee becomes eligible). The determination of whether a notice satisfies the timing requirement of this paragraph (d)(3) is based on all of the relevant facts and circumstances.

(ii) *Deemed satisfaction of timing requirement*. The timing requirement of this paragraph (d)(3) is deemed to be satisfied 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 employee for the plan year. In the case of an employee who does not receive the notice within the period described in the previous sentence because the employee be-

comes 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 employee becomes eligible (and no later than the date the employee becomes eligible). Thus, for example, the preceding sentence would apply in the case of any employee eligible for the first plan year under a newly established plan that provides for elective contributions, or would apply in the case of the first plan year in which an employee becomes eligible under an existing plan that provides for elective contributions.

(e) *Plan year requirement*—(1) *General rule*. Except as provided in this paragraph (e) or in paragraph (f) of this section, a plan will fail to satisfy the requirements of section 401(k)(12) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of the plan year and remain in effect for an entire 12-month plan year. In addition, except as provided in paragraph (g) of this section, a plan which includes provisions that satisfy the rules of this section will not satisfy the requirements of §1.401(k)–1(b) if it is amended to change such provisions for that plan year. Moreover, if, as described under paragraph (h)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions under that other plan specifying that the safe harbor contributions will be made and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) *Initial plan year*. A newly established plan (other than a successor plan within the meaning of §1.401(k)–2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (e) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a cash or deferred arrangement will not fail to satisfy the requirement of this paragraph (e) if it is added to an existing profit sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that—

(i) The plan is not a successor plan; and

(ii) The cash or deferred arrangement is made effective no later than 3 months prior to the end of the plan year.

(3) *Change of plan year.* A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section (determined without regard to paragraph (g) of this section) for the immediately following plan year (or for the immediately following 12 months if the immediately following plan year is less than 12 months).

(4) *Final plan year.* A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the final plan year is less than 12 months, provided that the plan satisfies the requirement of this section through the date of termination and either—

(i) The plan would satisfy the requirements of paragraph (g) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d).

(f) *Plan amendments adopting safe harbor nonelective contributions—(1) General rule.* Notwithstanding paragraph (e)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section, effective as of the first day of the plan year, using nonelective contributions under paragraph (b) of this section, but only if the plan provides the contingent and follow-up notices described in this section. A plan amendment made pursuant to this paragraph (f)(1) for a plan

year may provide for the use of the safe harbor method described in this section solely for that plan year and a plan sponsor is not limited in the number of years for which it is permitted to adopt an amendment providing for the safe harbor method of this section using nonelective contributions under paragraph (b) of this section and this paragraph (f).

(2) *Contingent notice provided.* A plan satisfies the requirement to provide the contingent notice under this paragraph (f)(2) if it provides a notice that would satisfy the requirements of paragraph (d) of this section, except that, in lieu of setting forth the safe harbor contributions used under the plan as set forth in paragraph (d)(2)(ii)(A) of this section, the notice specifies that the plan may be amended during the plan year to include the safe harbor nonelective contribution and that, if the plan is amended, a follow-up notice will be provided.

(3) *Follow-up notice requirement.* A plan satisfies the requirement to provide a follow-up notice under this paragraph (f)(3) if, no later than 30 days before the last day of the plan year, each eligible employee is given a notice that states that the safe harbor nonelective contributions will be made for the plan year. The notice must be in writing or in such other form as may be prescribed by the Commissioner and is permitted to be combined with a contingent notice provided under paragraph (f)(2) of this section for the next plan year.

(g) *Permissible reduction or suspension of safe harbor matching contributions—(1) General rule.* A plan that provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(k)(3) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective contributions (and, if applicable, employee contributions) provided that—

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (g)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (g)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(k)-2(a)(2)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (g)) with respect to amounts deferred through the effective date of the amendment.

(2) *Notice of suspension requirement.* The notice of suspension requirement of this paragraph (g)(2) is satisfied if each eligible employee is given a notice (in writing or such other form as prescribed by the Commissioner) that explains—

(i) The consequences of the amendment which reduces or suspends matching contributions on future elective contributions and, if applicable, employee contributions;

(ii) The procedures for changing their cash or deferred election and, if applicable, their employee contribution elections; and

(iii) The effective date of the amendment.

(h) *Additional rules—(1) Contributions taken into account.* A contribution is taken into account for purposes of this section for a plan year if and only if the contribution would be taken into account for such plan year under the rules of §1.401(k)-2(a) or 1.401(m)-2(a). Thus, for example, a safe harbor matching contribution must be made within 12 months of the end of the plan year. Similarly, an elective contribution that would be taken into account for a plan year under §1.401(k)-2(a)(4)(i)(B)(2) must be taken into account for such plan year for purposes of this section, even if the compensation would have been received after the close of the plan year.

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests.* A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies

section 401(a)(4). Thus, these contributions are not subject to the limitations on qualified nonelective contributions under §1.401(k)–2(a)(6)(ii), but are subject to the rules generally applicable to nonelective contributions under section 401(a)(4). See §1.401(a)(4)–1(b)(2)(ii). However, pursuant to section 401(k)(12)(E)(ii), to the extent they are needed to satisfy the safe harbor contribution requirement of paragraph (b) of this section, safe harbor nonelective contributions may not be taken into account under any plan for purposes of section 401(l) (including the imputation of permitted disparity under §1.401(a)(4)–7).

(3) *Early participation rules.* Section 401(k)(3)(F) and §1.401(k)–2(a)(1)(iii)(A), which provide an alternative nondiscrimination rule for certain plans that provide for early participation, do not apply for purposes of section 401(k)(12) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees. However, a plan is permitted to apply the rules of section 410(b)(4)(B) to treat the plan as two separate plans for purposes of section 410(b) and apply the safe harbor requirements of this section to one plan and apply the requirements of §1.401(k)–2 to the other plan. See §1.401(k)–1(b)(4)(vi), *Example 2*.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan.* Safe harbor matching or nonelective contributions may be made to the plan that contains the cash or deferred arrangement or to another defined contribution plan that satisfies section 401(a) or 403(a). If safe harbor contributions are made to another defined contribution plan, the safe harbor plan must specify the plan to which the safe harbor contributions are made and the contribution requirement of paragraph (b) or (c) of this section must be satisfied in the other defined contribution plan in the same manner as if the contributions were made to the plan that contains the cash or deferred arrangement. Consequently, the plan to which the contributions are made must have the same plan year as the plan containing the cash and deferred arrangement and each em-

ployee eligible under the plan containing the cash or deferred arrangement must be eligible under the same conditions under the other defined contribution plan. The plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

(5) *Contributions used only once.* Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

#### *§1.401(k)–4 SIMPLE 401(k) plan requirements.*

(a) *General rule.* A cash or deferred arrangement satisfies the SIMPLE 401(k) plan provision of section 401(k)(11) for a plan year if the arrangement satisfies the requirements of paragraphs (b) through (i) of this section for that year. A plan that contains a cash or deferred arrangement that satisfies this section is referred to as a SIMPLE 401(k) plan. Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the ADP test of section 401(k)(3)(A)(ii) for that year.

(b) *Eligible employer—(1) General rule.* A SIMPLE 401(k) plan must be established by an eligible employer. Eligible employer for purposes of this section means, with respect to any plan year, an employer that had no more than 100 employees who each received at least \$5,000 of SIMPLE compensation, as defined in paragraph (e)(5) of this section, from the employer for the prior calendar year.

(2) *Special rule.* An eligible employer that establishes a SIMPLE 401(k) plan for a plan year and that fails to be an eligible employer for any subsequent plan year, is treated as an eligible employer for the 2 plan years following the last plan year the employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence applies only if the provisions of section 410(b)(6)(C)(i) are satisfied.

(c) *Exclusive plan—(1) General rule.* The SIMPLE 401(k) plan must be the exclusive plan for each SIMPLE 401(k) plan participant for the plan year. This requirement is satisfied if there are no contributions made, or benefits accrued, for services during the plan year on behalf of

any SIMPLE 401(k) plan participant under any other qualified plan maintained by the employer. Other qualified plan for purposes of this section means any plan, contract, pension, or trust described in section 219(g)(5)(A) or (B).

(2) *Special rule.* A SIMPLE 401(k) plan will not be treated as failing the requirements of this paragraph (c) merely because any SIMPLE 401(k) plan participant receives an allocation of forfeitures under another plan of the employer.

(d) *Election and notice—(1) General rule.* An eligible employer establishing or maintaining a SIMPLE 401(k) plan must satisfy the election and notice requirements in paragraphs (d)(2) and (3) of this section.

(2) *Employee elections—(i) Initial plan year of participation.* For the plan year in which an employee first becomes eligible under the SIMPLE 401(k) plan, the employee must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before.

(ii) *Subsequent plan years.* For each subsequent plan year, each eligible employee must be permitted to make or modify his cash or deferred election during the 60-day period immediately preceding such plan year.

(iii) *Election to terminate.* An eligible employee must be permitted to terminate his cash or deferred election at any time. If an employee does terminate his cash or deferred election, the plan is permitted to provide that such employee cannot have elective contributions made under the plan for the remainder of the plan year.

(3) *Employee notices.* The employer must notify each eligible employee within a reasonable time prior to each 60-day election period, or on the day the election period starts, that he or she can make a cash or deferred election, or modify a prior election, if applicable, during that period. The notice must state whether the eligible employer will make the matching contributions described in paragraph (e)(3) of this section or the nonelective contributions described in paragraph (e)(4) of this section.

(e) *Contributions—(1) General rule.* A SIMPLE 401(k) plan satisfies the contribution requirements of this paragraph (e) for a plan year only if no contribu-

tions may be made to the SIMPLE 401(k) plan during such year, other than contributions described in this paragraph (e) and rollover contributions described in §1.402(c)-2, Q&A-1(a).

(2) *Elective contributions.* Subject to the limitations on annual additions under section 415, each eligible employee must be permitted to make an election to have up to \$10,000 of elective contributions made on the employee's behalf under the SIMPLE 401(k) plan for a plan year. The \$10,000 limit is increased beginning in 2006 in the same manner as the \$160,000 amount is adjusted under section 415(d), except that pursuant to section 408(p)(2)(E)(ii) the base period shall be the calendar quarter beginning July 1, 2004, and any increase which is not a multiple of \$500 is rounded to the next lower multiple of \$500.

(3) *Matching contributions.* Each plan year, the eligible employer must contribute a matching contribution to the account of each eligible employee on whose behalf elective contributions were made for the plan year. The amount of the matching contribution must equal the lesser of the eligible employee's elective contributions for the plan year or 3% of the eligible employee's SIMPLE compensation for the entire plan year.

(4) *Nonelective contributions.* For any plan year, in lieu of contributing matching contributions described in paragraph (e)(3) of this section, an eligible employer may, in accordance with plan terms, contribute a nonelective contribution to the account of each eligible employee in an amount equal to 2% of the eligible employee's SIMPLE compensation for the entire plan year. The eligible employer may limit the nonelective contributions to those eligible employees who received at least \$5,000 of SIMPLE compensation from the employer for the entire plan year.

(5) *SIMPLE compensation.* Except as otherwise provided, the term *SIMPLE compensation* for purposes of this section means the sum of wages, tips, and other compensation from the eligible employer subject to federal income tax withholding (as described in section 6051(a)(3)) and the employee's elective contributions made under any other plan, and if applicable, elective deferrals under a section 408(p) SIMPLE IRA plan, a section 408(k)(6) SARSEP, or a plan or

contract that satisfies the requirements of section 403(b), and compensation deferred under a section 457 plan, required to be reported by the employer on Form W-2 (as described in section 6051(a)(8)). For self-employed individuals, SIMPLE compensation means net earnings from self-employment determined under section 1402(a) prior to subtracting any contributions made under the SIMPLE 401(k) plan on behalf of the individual.

(f) *Vesting.* All benefits attributable to contributions described in paragraph (e) of this section must be nonforfeitable at all times.

(g) *Plan year.* The plan year of a SIMPLE 401(k) plan must be the whole calendar year. Thus, in general, a SIMPLE 401(k) plan can be established only on January 1 and can be terminated only on December 31. However, in the case of an employer that did not previously maintain a SIMPLE 401(k) plan, the establishment date can be as late as October 1 (or later in the case of an employer that comes into existence after October 1 and establishes the SIMPLE 401(k) plan as soon as administratively feasible after the employer comes into existence).

(h) *Other rules.* A SIMPLE 401(k) plan is not treated as a top-heavy plan under section 416. See section 416(g)(4)(G).

*§1.401(k)-5 Special rules for mergers, acquisitions and similar events.*  
[Reserved].

*§1.401(k)-6 Definitions.*

Unless otherwise provided, the definitions of this section govern for purposes of section 401(k) and the regulations thereunder.

*Actual contribution percentage (ACP) test.* *Actual contribution percentage test* or *ACP test* means the test described in §1.401(m)-2(a)(1).

*Actual deferral percentage (ADP).* *Actual deferral percentage* or *ADP* means the ADP of the group of eligible employees as defined in §1.401(k)-2(a)(2).

*Actual deferral percentage (ADP) test.* *Actual deferral percentage test* or *ADP test* means the test described in §1.401(k)-2(a)(1).

*Actual deferral ratio (ADR).* *Actual deferral ratio* or *ADR* means the ADR

of an eligible employee as defined in §1.401(k)-2(a)(3).

*Cash or deferred arrangement.* *Cash or deferred arrangement* is defined in §1.401(k)-1(a)(2).

*Cash or deferred election.* *Cash or deferred election* is defined in §1.401(k)-1(a)(3).

*Compensation.* *Compensation* means compensation as defined in section 414(s) and §1.414(s)-1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. In the case of an HCE whose ADR is determined under §1.401(k)-2(a)(3)(ii), period of participation includes periods under another plan for which elective contributions are aggregated under §1.401(k)-2(a)(3)(ii). See also section 401(a)(17) and §1.401(a)(17)-1(c)(1).

*Current year testing method.* *Current year testing method* means the testing method described in §1.401(k)-2(a)(2)(ii) or 1.401(m)-2(a)(2)(ii) under which the applicable year is the current plan year.

*Elective contributions.* *Elective contributions* means employer contributions made to a plan pursuant to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under §1.401(k)-1(a)(4)).

*Eligible employee—(1) General rule.* *Eligible employee* means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts.

(2) *Conditions on eligibility.* An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See §1.401(k)-1(e)(5), however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, no later than the employee's first becoming eligible to make a cash or deferred election under any plan or arrangement of the employer (described in section 219(g)(5)(A)), is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan or arrangement maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in §1.401(k)-1(a)(3)(v) relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994, treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan or arrangement (whether or not terminated) of the employer.

*Eligible HCE.* *Eligible HCE* means an eligible employee who is an HCE.

*Eligible NHCE.* *Eligible NHCE* means an eligible employee who is not an HCE.

*Employee.* *Employee* means an employee within the meaning of §1.410(b)-9.

*Employee stock ownership plan (ESOP).* *Employee stock ownership plan* or *ESOP* means the portion of a plan that is an ESOP within the meaning of §1.410(b)-7(c)(2).

*Employer.* *Employer* means an employer within the meaning of §1.410(b)-9.

*Excess contributions.* *Excess contributions* means, with respect to a plan year, the amount of total excess contributions apportioned to an HCE under §1.401(k)-2(b)(2)(iii).

*Excess deferrals.* *Excess deferrals* means excess deferrals as defined in §1.402(g)-1(e)(3).

*Highly compensated employee (HCE).* *Highly compensated employee* or *HCE* has the meaning provided in section 414(q).

*Matching contributions.* *Matching contributions* means matching contributions as defined in §1.401(m)-1(a)(2).

*Nonelective contributions.* *Nonelective contributions* means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

*Non-employee stock ownership plan (non-ESOP).* *Non-employee stock ownership plan* or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)-7(c)(2).

*Non-highly compensated employee (NHCE).* *Non-highly compensated employee* or *NHCE* means an employee who is not an HCE.

*Plan.* *Plan* is defined in §1.401(k)-1(b)(4).

*Pre-ERISA money purchase pension plan.* (1) *Pre-ERISA money purchase pension plan* is a pension plan—

(i) That is a defined contribution plan (as defined in section 414(i));

(ii) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement; and

(iii) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(2) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

*Prior year testing method.* *Prior year testing method* means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)-2(a)(2)(ii) or 1.401(m)-2(a)(2)(ii).

*Qualified matching contributions (QMACs).* *Qualified matching contributions* or *QMACs* means matching contributions that, except as provided otherwise in §1.401(k)-1(c) and (d), satisfy the requirements of §1.401(k)-1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ACP test under §1.401(m)-2(a)(6). Thus, the matching contributions must satisfy the vesting requirements of §1.401(k)-1(c) and be subject to the distribution requirements of §1.401(k)-1(d) when they are contributed to the plan. See also §1.401(k)-2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) as a result of being a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

*Qualified nonelective contributions (QNECs).* *Qualified nonelective contributions* or *QNECs* means employer contributions, other than elective contributions or matching contributions, that, except as provided otherwise in §1.401(k)-1(c) and (d), satisfy the requirements of §1.401(k)-1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ACP test under §1.401(m)-2(a)(6). Thus, the nonelective contributions must satisfy the vesting requirements of §1.401(k)-1(c) and be subject to the distribution requirements of §1.401(k)-1(d) when they are contributed to the plan.

*Rural cooperative plans.* *Rural cooperative plan* means a plan described in section 401(k)(7).

Par. 5. Sections 1.401(m)-0 through 1.401(m)-2 are revised and sections 1.401(m)-3 through 1.401(m)-5 are added to read as follows:

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This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(m)-1 through 1.401(m)-5.

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§1.401(m)-4 *Special rules for mergers, acquisitions and similar events.*

[Reserved].

§1.401(m)-5 *Definitions.*

§1.401(m)-1 *Employee contributions and matching contributions.*

(a) *General nondiscrimination rules*—(1) *Nondiscriminatory amount of contributions*—(i) *Exclusive means of amounts testing.* A defined contribution plan does not satisfy section 401(a) for a plan year unless the amount of employee contributions and matching contributions to the plan for the plan year satisfies section 401(a)(4). The amount of employee contributions and matching contributions under a plan satisfies the requirements of section 401(a)(4) with respect to amounts if and only if the amount of employee contributions and matching contributions satisfies the nondiscrimination test of section 401(m) under paragraph (b) of this section and the plan satisfies the additional requirements of paragraph (c) of this section. See §1.401(a)(4)-1(b)(2)(ii)(B).

(ii) *Testing benefits, rights and features.* A plan that provides for employee contributions or matching contributions must satisfy the requirements of section 401(a)(4) relating to benefits, rights and features in addition to the requirement regarding amounts described in paragraph (a)(1)(i) of this section. For example, the right to make each level of employee contributions and the right to each level of matching contributions under the plan are benefits, rights or features subject to the requirements of section 401(a)(4). See §1.401(a)(4)-4(e)(3)(i) and (iii)(F) through (G).

(2) *Matching contributions*—(i) *In general.* For purposes of section 401(m), this section and §§1.401(m)-2 through 1.401(m)-5, matching contributions are—

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral; and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals.

(ii) *Employer contributions made on account of an employee contribution or elective deferral.* Whether an employer contribution is made on account of an employee contribution or an elective deferral is determined on the basis of all the relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. An employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is intended to be a qualified plan or other arrangement described in §1.402(g)-1(b) is not a matching contribution.

(iii) *Employer contributions not on account of an employee contribution or elective deferral—(A) General rule.* Employer contributions are not matching contributions made on account of elective deferrals if they are contributed before the cash or deferred election is made or before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier). In addition, an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution.

(B) *Exceptions for forfeitures and released ESOP shares.* The rule of paragraph (a)(3)(iii)(A) of this section does not apply to a forfeiture that is allocated as a matching contribution. In addition, an allocation of shares from an ESOP loan suspense account described in §54.4975-11(c) and (d) of this chapter will not fail to be treated as a matching contribution solely because the employer contribution that resulted in the release and allocation of those shares from the suspense account is made before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier) provided that—

(I) The contribution is for a required payment that is due under the loan terms; and

(2) The contribution is not made early with a principal purpose of accelerating deductions.

(C) *Exception for bona fide administrative considerations.* The timing of contributions will not be treated as failing to satisfy the requirements of this paragraph (a)(3)(iii) merely because contributions are occasionally made before the employees' performance of services with respect to which the elective deferrals are made (or when the cash that is subject to the cash or deferred elections would be currently available, if earlier) in order to accommodate *bona fide* administrative considerations and are not paid early with a principal purpose of accelerating deductions.

(3) *Employee contributions—(i) In general.* For purposes of section 401(m), this section and §§1.401(m)-2 through 1.401(m)-5, employee contributions are contributions to a plan that are designated or treated at the time of contribution as after-tax employee contributions (*e.g.*, by treating the contributions as taxable income subject to applicable withholding requirements) and are allocated to an individual account for each eligible employee to which attributable earnings and losses are allocated. See §1.401(k)-1(a)(2)(ii). The term *employee contributions* includes—

(A) Employee contributions to the defined contribution portion of a plan described in section 414(k);

(B) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(C) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions under §1.401(k)-2(b)(3); and

(D) Employee contributions to a plan or contract that satisfies the requirements of section 403(b).

(ii) *Certain contributions not treated as employee contributions.* The term *employee contributions* does not include designated Roth contributions, repayment of loans, rollover contributions, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to the plan from another plan.

(iii) *Qualified cost-of-living arrangements.* Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B) are treated as employee contributions to a defined contribution plan, without regard to the requirement that the employee contributions be allocated to an individual account to which attributable earnings and losses are allocated.

(b) *Nondiscrimination requirements for amount of contributions—(1) Matching contributions and employee contributions.* The matching contributions and employee contributions under a plan satisfy this paragraph (b) for a plan year only if the plan satisfies—

(i) The ACP test of section 401(m)(2) described in §1.401(m)-2;

(ii) The ACP safe harbor provisions of section 401(m)(11) described in §1.401(m)-3; or

(iii) The SIMPLE 401(k) provisions of sections 401(k)(11) and 401(m)(10) described in §1.401(k)-4.

(2) *Automatic satisfaction by certain plans.* Notwithstanding paragraph (b)(1) of this section, the requirements of this section are treated as satisfied with respect to employee contributions and matching contributions under a collectively bargained plan (or the portion of a plan) that automatically satisfies section 410(b). See §§1.401(a)(4)-1(c)(5) and 1.410(b)-2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a State or local government or political subdivision thereof (or agency or instrumentality thereof) and, accordingly such plans are not required to comply with this section. See sections 401(a)(5)(G), 403(b)(12)(C) and 410(c)(1)(A).

(3) *Anti-abuse provisions.* Sections 1.401(m)-1 through 1.401(m)-5 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ACP for NHCEs (which is used as a benchmark for testing the ACP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this



paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring*—(i) *In general.* This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans that provide for employee contributions and matching contributions for purposes of this section and §§1.401(m)–2 through 1.401(m)–5.

(ii) *Aggregation of employee contributions and matching contributions within a plan.* Except as otherwise specifically provided in this paragraph (b)(4) and §1.401(m)–3(j)(6), a plan must be subject to a single test under paragraph (b)(1) of this section with respect to all employee contributions and matching contributions and all eligible employees under the plan. Thus, for example, if two groups of employees are eligible for matching contributions under a plan, all employee contributions and matching contributions under the plan must be subject to a single test, even if they have significantly different features, such as different rates of match.

(iii) *Aggregation of plans*—(A) *In general.* The term *plan* means a plan within the meaning of §1.410(b)–7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c), and the permissive aggregation rules of §1.410(b)–7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)–7(d) are treated as a single plan for purposes of sections 401(k) and 401(m).

(B) *Arrangements with inconsistent ACP testing methods.* Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all employee contributions and matching contributions and all eligible employees under a plan. Thus, in applying the permis-

sive aggregation rules of §1.410(b)–7(d), an employer may not aggregate plans (within the meaning of §1.410(b)–7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)–7) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)–7) that is using the ACP safe harbor provisions of section 401(m)(11) and another plan that is using the ACP test of section 401(m)(2).

(iv) *Disaggregation of plans and separate testing*—(A) *In general.* If employee contributions or matching contributions are included in a plan (within the meaning of §1.410(b)–7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the matching contributions and employee contributions under that plan must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a plan which provides for employee contributions or matching contributions are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(m), unless the employer is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan. Similarly, if a plan that provides for employee contributions or matching contributions under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the plan must be treated as two separate plans, one comprising all eligible employees who have met the minimum age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the minimum age and service requirements of section 410(a)(1), unless the plan is using the rule in §1.401(m)–2(a)(1)(iii)(A).

(B) *Restructuring prohibited.* Restructuring under §1.401(a)(4)–9(c) may not

be used to demonstrate compliance with the requirements of section 401(m). See §1.401(a)(4)–9(c)(3)(ii).

(v) *Certain disaggregation rules not applicable.* The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)–7(c)(1) and to ESOP and non-ESOP portions of a plan set forth in §1.410(b)–7(c)(2) shall not apply for purposes of this section and §§1.401(m)–2 through 1.401(m)–5. Accordingly, notwithstanding §1.410(b)–7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of section 414(l), as described in §1.410(b)–7(b)) are permitted to be aggregated for these purposes.

(c) *Additional requirements*—(1) *Separate testing for employee contributions and matching contributions.* Under §1.410(b)–7(c)(1), the group of employees who are eligible to make employee contributions or eligible to receive matching contributions must satisfy the requirements of section 410(b) as if those employees were covered under a separate plan. The determination of whether the separate plan satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. In addition, except as expressly permitted under section 401(k), 410(b)(2)(A)(ii), or 416(c)(2)(A), employee contributions, matching contributions and elective contributions taken into account under §1.401(m)–2(a)(6) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee contributions or matching contributions are made) satisfy the requirements of section 401(a). See also §1.401(a)(4)–11(g)(3)(vii) for special rules relating to corrections of violations of the minimum coverage requirements or discriminatory rates of matching contributions.

(2) *Plan provision requirement.* A plan that provides for employee contributions or matching contributions satisfies this section only if it provides that the nondiscrimination requirements of section 401(m) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1) of this section and, if with respect to that alternative there are optional choices,

which of the optional choices will apply. For example, a plan that uses the ACP test of section 401(m)(2), as described in paragraph (b)(1)(i) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ACP for eligible NHCEs for the first plan year is 3% or the ACP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(m)(11), as described in paragraph (b)(1)(ii) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ACP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (c)(2), a plan may incorporate by reference the provisions of section 401(m)(2) and §1.401(m)-2 if that is the nondiscrimination test being applied. The Commissioner may, in guidance of general applicability, published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), specify the options that will apply under the plan if the nondiscrimination test is incorporated by reference in accordance with the preceding sentence.

(d) *Effective date*—(1) *General rule*. Except as otherwise provided in this paragraph (d), this section and §§1.401(m)-2 through 1.401(m)-5 apply to plan years that begin on or after January 1, 2006.

(2) *Early implementation permitted*. A plan is permitted to apply the rules of this section and §§1.401(m)-2 through 1.401(m)-5 to any plan year that ends after December 29, 2004, provided the plan applies all the rules of this section and §§1.401(m)-2 through 1.401(m)-5 and all the rules of §§1.401(k)-1 through 1.401(k)-6, to the extent applicable, for that plan year and all subsequent plan years.

(3) *Applicability of prior regulations*. For any plan year, before a plan applies this section and §§1.401(m)-2 through 1.401(m)-5 (either the first plan year beginning on or after January 1, 2006 or such earlier year, as provided in paragraph (d)(2) of this section), §1.401(m)-1 and §1.401(m)-2 (as they appeared in the April 1, 2004 edition of 26 CFR part 1) apply to the plan to the extent those sections, as

they so appear, reflect the statutory provisions of section 401(m) as in effect for the relevant year.

#### *§1.401(m)-2 ACP test.*

(a) *Actual contribution percentage (ACP) test*—(1) *In general*—(i) *ACP test formula*. A plan satisfies the ACP test for a plan year only if—

(A) The ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ACP for the eligible HCEs for the plan year over the ACP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees*. If, for the applicable year there are no eligible NHCEs (*i.e.*, all of the eligible employees under the plan for the applicable year are HCEs), the plan is deemed to satisfy the ACP test.

(iii) *Special rule for early participation*. If a plan providing for employee contributions or matching contributions provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the plan meets the requirements of section 410(b)(1), then in determining whether the plan meets the requirements under paragraph (a)(1) of this section either—

(A) Pursuant to section 401(m)(5)(C), the ACP test is performed under the plan (determined without regard to disaggregation under §1.410(b)-7(c)(3)), using the ACP for all eligible HCEs for the plan year and the ACP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(m)-1(b)(4), the plan is disaggregated into separate plans and the ACP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ACP*—(i) *General rule*. The ACP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ACRs of eligible employees in the group for that year. The ACP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method*. The ACP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ACP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ACP test is being calculated. Under the prior year testing method, the ACP for the eligible NHCEs is determined using the ACRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ACP test is being performed. Under the current year testing method, the applicable year for determining the ACP for eligible NHCEs is the same plan year as the plan year for which the ACP test is being calculated. Under either method, the ACP for the eligible HCEs is determined using the ACRs of eligible employees who are HCEs for the plan year for which the ACP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ACR*—(i) *General rule*. The ACR of an eligible employee for the plan year or applicable year is the sum of the employee contributions and matching contributions taken into account with respect to such employee (determined under the rules of paragraphs (a)(4) and (5) of this section), and the qualified nonelective and elective contributions taken into account under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ACR is calculated to the nearest hundredth of a percentage point. If no employee contributions, matching contributions, elective contributions, or qualified nonelective contributions are taken into account under this section with respect to an eligible employee for the year, the ACR of the employee is zero.

(ii) *ACR of HCEs eligible under more than one plan*—(A) *General rule.* Pursuant to section 401(m)(2)(B), the ACR of an HCE who is an eligible employee in more than one plan of an employer to which matching contributions or employee contributions are made is calculated by treating all contributions with respect to such HCE under any such plan as being made under the plan being tested. Thus, the ACR for such an HCE is calculated by accumulating all matching contributions and employee contributions under any plan (other than a plan described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the plan under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ACR for the plan year of that plan for an HCE who participates in multiple plans of the same employer that provide for matching contributions or employee contributions is the sum of all such contributions during such 12-month period that would be taken into account with respect to the HCE under all plans in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(m)–3.

(B) *Plans not permitted to be aggregated.* Contributions under plans that are not permitted to be aggregated under §1.401(m)–1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(m)–1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)–7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Example.* The following example illustrates the application of paragraph (a)(3)(ii) of this section. See also §1.401(k)–2(a)(3)(iii) for additional examples of the application of the parallel rule under section 401(k)(3)(A). The example is as follows:

*Example.* Employee A, an HCE with compensation of \$120,000, is eligible to make employee contributions under Plan S and Plan T, two calendar-year profit-sharing plans of Employer H. Plan

S and Plan T use the same definition of compensation. Plan S provides a match equal to 50% of each employee's contributions and Plan T has no match. During the current plan year, Employee A elects to contribute \$4,000 in employee contributions to Plan T and \$4,000 in employee contributions to Plan S. There are no other contributions made on behalf of Employee A. Each plan must calculate Employee A's ACR by dividing the total employee contributions by Employee A and matching contributions under both plans by \$120,000. Therefore, Employee A's ACR under each plan is 8.33% ( $\$4,000 + \$4,000 + \$2,000 / \$120,000$ ).

(4) *Employee contributions and matching contributions taken into account under the ACP test*—(i) *Employee contributions.* An employee contribution is taken into account in determining the ACR for an eligible employee for the plan year or applicable year in which the contribution is made. For purposes of the preceding sentence, an amount withheld from an employee's pay (or a payment by the employee to an agent of the plan) is treated as contributed at the time of such withholding (or payment) if the funds paid are transmitted to the trust within a reasonable period after the withholding (or payment).

(ii) *Recharacterized elective contributions.* Excess contributions recharacterized in accordance with §1.401(k)–2(b)(3) are taken into account as employee contributions for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under §1.401(k)–2(b)(3)(ii).

(iii) *Matching contributions.* A matching contribution is taken into account in determining the ACR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied—

(A) The matching contribution is allocated to the employee's account under the terms of the plan as of a date within that year;

(B) The matching contribution is made on account of (or the matching contribution is allocated on the basis of) the employee's elective deferrals or employee contributions for that year; and

(C) The matching contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year that contains that date.

(5) *Employee contributions and matching contributions not taken into account under the ACP test*—(i) *General rule.* Matching contributions that do not satisfy the requirements of paragraph (a)(4)(iii)

of this section may not be taken into account in the ACP test for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the ACP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Disproportionate matching contributions*—(A) *Matching contributions in excess of 100%.* A matching contribution with respect to an elective deferral for an NHCE is not taken into account under the ACP test to the extent it exceeds the greatest of:

(1) 5% of compensation;

(2) the employee's elective deferrals for a year; and

(3) the product of 2 times the plan's representative matching rate and the employee's elective deferrals for a year.

(B) *Representative matching rate.* For purposes of this paragraph (a)(5)(ii), the plan's representative matching rate is the lowest matching rate for any eligible NHCE among a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year who make elective deferrals for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals for the plan year).

(C) *Definition of matching rate.* For purposes of this paragraph (a)(5)(ii), the matching rate for an employee generally is the matching contributions made for such employee divided by the employee's elective deferrals for the year. If the matching rate is not the same for all levels of elective deferrals for an employee, the employee's matching rate is determined assuming that an employee's elective deferrals are equal to 6 percent of compensation.

(D) *Application to matching contributions that match employee contributions.* If a plan provides a match with respect to the sum of the employee's employee contributions and elective deferrals, that sum is substituted for the amount of the employee's elective deferrals in paragraphs (a)(5)(ii)(A) and (C) of this section

and employees who make either employee contributions or elective deferrals are taken into account under paragraph (a)(5)(ii)(B) of this section. Similarly, if a plan provides a match with respect to the employee's employee contributions, but not elective deferrals, the employee's employee contributions are substituted for the amount of the employee's elective deferrals in paragraphs (a)(5)(ii) (A) and (C) of this section and employees who make employee contributions are taken into account under paragraph (a)(5)(ii)(B) of this section.

(iii) *Qualified matching contributions used to satisfy the ADP test.* Qualified matching contributions that are taken into account for the ADP test of section 401(k)(3) under §1.401(k)-2(a)(6) are not taken into account in determining an eligible employee's ACR.

(iv) *Matching contributions taken into account under safe harbor provisions.* A plan that satisfies the ACP safe harbor requirements of section 401(m)(11) for a plan year but nonetheless must satisfy the requirements of this section because it provides for employee contributions for such plan year is permitted to apply this section disregarding all matching contributions with respect to all eligible employees. In addition, a plan that satisfies the ADP safe harbor requirements of §1.401(k)-3 for a plan year using qualified matching contributions but does not satisfy the ACP safe harbor requirements of section 401(m)(11) for such plan year is permitted to apply this section by excluding matching contributions with respect to all eligible employees that do not exceed 4% of each employee's compensation. If a plan disregards matching contributions pursuant to this paragraph (a)(5)(iv), the disregard must apply with respect to all eligible employees.

(v) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution is not taken into account for purposes of this section.

(vi) *Additional employee contributions or matching contributions pursuant to section 414(u).* Additional employee contributions and matching contributions made by reason of an eligible employee's qualified military service under section 414(u)

are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions are made, or for any other plan year.

(6) *Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test.* Qualified nonelective contributions and elective contributions may be taken into account in determining the ACR for an eligible employee for a plan year or applicable year, but only to the extent the contributions satisfy the following requirements—

(i) *Timing of allocation.* The qualified nonelective contribution is allocated to the employee's account as of a date within that year (within the meaning of §1.401(k)-2(a)(4)(i)(A)) and the elective contribution satisfies §1.401(k)-2(a)(4)(i). Consequently, under the prior year testing method, in order to be taken into account in calculating the ACP for the group of eligible NHCEs for the applicable year, a qualified nonelective contribution must be contributed no later than the end of the 12-month period following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Elective contributions taken into account under the ACP test.* Elective contributions may be taken into account for the ACP test only if the cash or deferred arrangement under which the elective contributions are made is required to satisfy the ADP test in §1.401(k)-2(a)(1) and, then only to the extent that the cash or deferred arrangement would satisfy that test, including such elective contributions in the ADP for the plan year or applicable year. Thus, for example, elective deferrals made pursuant to a salary reduction agreement under an annuity described in section 403(b) are not permitted to be taken into account in an ACP test. Similarly, elective contributions under a cash or deferred arrangement that is using the section 401(k) safe harbor described in §1.401(k)-3 cannot be taken into account in an ACP test.

(iii) *Requirement that amount satisfy section 401(a)(4).* The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)-2(a)(6), and the amount of nonelective contributions,

excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) for the ACP test and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)-2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)-1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)-1(c)(2)(ii) with respect to the plan, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iv) *Aggregation must be permitted.* The plan that provides for employee or matching contributions and the plan or plans to which the qualified nonelective contributions or elective contributions are made are plans that would be permitted to be aggregated under §1.401(m)-1(b)(4). If the plan year of the plan that provides for employee or matching contributions is changed to satisfy the requirement under §1.410(b)-7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and elective contributions may be taken into account in the resulting short plan year only if such qualified nonelective and elective contributions could have been taken into account under an ADP test for a plan with that same short plan year.

(v) *Disproportionate contributions not taken into account—(A) General rule.* Qualified nonelective contributions cannot be taken into account for an applicable year for an NHCE to the extent such contributions exceed the product of that

NHCE's compensation and the greater of 5% and 2 times the plan's representative contribution rate. Any qualified nonelective contribution taken into account in an ADP test under §1.401(k)-2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(k)-2(a)(6)(iv)(B)) is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate for purposes of paragraph (a)(6)(v)(B) of this section).

(B) *Definition of representative contribution rate.* For purposes of this paragraph (a)(6)(v), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the applicable year and who is employed by the employer on the last day of the applicable year).

(C) *Definition of applicable contribution rate.* For purposes of this paragraph

(a)(6)(v), the applicable contribution rate for an eligible NHCE is the sum of the matching contributions taken into account under this section for the employee for the plan year and the qualified nonelective contributions made for that employee for the plan year, divided by that employee's compensation for the same period.

(D) *Special rule for prevailing wage contributions.* Notwithstanding paragraph (a)(6)(v)(A) of this section, qualified nonelective contributions that are made in connection with an employer's obligation to pay prevailing wages under the Davis-Bacon Act (46 Stat. 1494), Public Law 71-798, Service Contract Act of 1965 (79 Stat. 1965), Public Law 89-286, or similar legislation can be taken into account for a plan year for an NHCE to the extent such contributions do not exceed 10 percent of that NHCE's compensation.

(vi) *Contribution only used once.* Qualified nonelective contributions cannot be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ACP test, any ADP test, or the requirements of §1.401(k)-3,

1.401(m)-3 or 1.401(k)-4. Thus, for example, qualified nonelective contributions that are made pursuant to §1.401(k)-3(b) cannot be taken into account under the ACP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(m)-2(c)(1), qualified nonelective contributions that are taken into account under the current year testing method for a plan year may not be taken into account under the prior year testing method for the next plan year.

(7) *Examples.* The following examples illustrate the application of this paragraph (a). See §1.401(k)-2(a)(6) for additional examples of the parallel rules under section 401(k)(3)(A). The examples are as follows:

*Example 1.* (i) Employer L maintains Plan U, a profit-sharing plan under which \$.50 matching contributions are made for each dollar of employee contributions. Plan U uses the current year testing method. The chart below shows the average employee contributions (as a percentage of compensation) and matching contributions (as a percentage of compensation) for Plan U's HCEs and NHCEs for the 2006 plan year:

|                                 | Employee Contributions | Matching Contributions | Actual Contribution Percentage |
|---------------------------------|------------------------|------------------------|--------------------------------|
| Highly compensated employees    | 4%                     | 2%                     | 6%                             |
| Nonhighly compensated employees | 3%                     | 1.5%                   | 4.5%                           |

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees.

(iii) Because the ACP for the HCEs (6.0%) exceeds 5.63% (4.5% x 1.25), Plan U does not satisfy the ACP test under paragraph (a)(1)(i)(A) of this section. However, because the ACP for the HCEs does not exceed the ACP for the NHCEs by more than 2

percentage points and the ACP for the HCEs does not exceed the ACP for the NHCEs multiplied by 2 (4.5% x 2 = 9%), the plan satisfies the ACP test under paragraph (a)(1)(i)(B) of this section.

*Example 2.* (i) Employees A through F are eligible employees in Plan V, a profit-sharing plan of Employer M that includes a cash or deferred arrangement and permits employee contributions. Under Plan V, a \$.50 matching contribution is made for each dollar of elective contributions and employee contributions.

Plan V uses the current year testing method and does not provide for elective contributions to be taken into account in determining an eligible employee's ACR. For the 2006 plan year, Employees A and B are HCEs and the remaining employees are NHCEs. The compensation, elective contributions, employee contributions, and matching contributions for the 2006 plan year are shown in the following table:

| Employee | Compensation | Elective Contributions | Employee Contributions | Matching Contributions |
|----------|--------------|------------------------|------------------------|------------------------|
| A        | \$190,000    | \$15,000               | \$ 3,500               | \$9,250                |
| B        | 100,000      | \$ 5,000               | \$10,000               | \$7,500                |
| C        | 85,000       | \$12,000               | \$0                    | \$6,000                |
| D        | 70,000       | \$ 9,500               | \$0                    | \$4,750                |
| E        | 40,000       | \$10,000               | \$0                    | \$5,000                |
| F        | 10,000       | \$0                    | \$0                    | \$0                    |

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining

the ACR of eligible employees, as shown in the following table:

| Employee | Compensation | Employee Contributions | Matching Contributions | ACR % |
|----------|--------------|------------------------|------------------------|-------|
| A        | \$190,000    | \$ 3,500               | \$9,250                | 6.71  |
| B        | 100,000      | \$10,000               | \$7,500                | 17.50 |
| C        | 85,000       | \$0                    | \$6,000                | 7.06  |
| D        | 70,000       | \$0                    | \$4,750                | 6.79  |
| E        | 40,000       | \$0                    | \$5,000                | 12.50 |
| F        | 10,000       | \$0                    | \$0                    | 0     |

(iii) The ACP for the HCEs is 12.11%  $((6.71\% + 17.50\%)/2)$ . The ACP for the NHCEs is 6.59%  $((7.06\% + 6.79\% + 12.50\% + 0\%)/4)$ . Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(A) of this section because the ACP of HCEs is more than 125% of the ACP of the NHCEs  $(6.59\% \times 1.25 = 8.24\%)$ . In addition, Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(B) of this section because the ACP for the HCEs exceeds the ACP of the other employees by more than 2 percentage points  $(6.59\% + 2\% = 8.59\%)$ . Therefore, the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

*Example 3.* (i) The facts are the same as *Example 2*, except that the plan provides that the NHCEs' elective contributions may be used to meet the require-

ments of section 401(m) to the extent needed under that section.

(ii) Pursuant to paragraph (a)(6)(ii) of this section, the \$10,000 of elective contributions for Employee E may be taken into account in determining the ACP rather than the ADP to the extent that the plan satisfies the requirements of §1.401(k)-2(a)(1) excluding from the ADP this \$10,000. In this case, if the \$10,000 were excluded from the ADP for the NHCEs, the ADP for the HCEs is 6.45%  $(7.89\% + 5.00\%)/2$  and the ADP for the NHCEs would be 6.92%  $(14.12\% + 13.57\% + 0\% + 0\%)/4$  and the plan would satisfy the requirements of §1.401(k)-2(a)(1) excluding from the ADP the elective contributions for NHCEs that are taken into account under section 401(m).

(iii) After taking into account the \$10,000 of elective contributions for Employee E in the ACP test,

the ACP for the NHCEs is 12.84%  $(7.06\% + 6.79\% + 37.50\% + 0\%)/4$ . Therefore the plan satisfies the ACP test because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs.

*Example 4.* (i) The facts are the same as *Example 2*, except that Plan V provides for a higher than 50% match rate on the elective contributions and employee contributions for all NHCEs. The match rate is defined as the rate, rounded up to the next whole percent, necessary to allow the plan to satisfy the ACP test, but not in excess of 100%. In this case, an increase in the match rate from 50% to 74% will be sufficient to allow the plan to satisfy the ACP test. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions at a 74% match rate of the eligible NHCEs (employees C through F) are shown in the following table:

| Employee | Compensation | Elective Contributions | Employee Contributions | Matching Contributions |
|----------|--------------|------------------------|------------------------|------------------------|
| C        | \$85,000     | \$12,000               | \$0                    | \$8,880                |
| D        | 70,000       | \$ 9,500               | \$0                    | \$7,030                |
| E        | 40,000       | \$10,000               | \$0                    | \$7,400                |
| F        | 10,000       | \$0                    | \$0                    | \$0                    |

(ii) The matching rate for all NHCEs is 74% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Therefore, the matching contributions may be taken into account in determining the ACP for the NHCEs.

(iii) The ACP for the NHCEs is 9.75%  $(10.45\% + 10.04\% + 18.50\% + 0\%)/4$ . Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP

for the NHCEs, the plan satisfies the requirements of section 401(m).

*Example 5.* (i) The facts are the same as *Example 4*, except that: Employee E's elective contributions are \$2,000 (rather than \$10,000) and pursuant to paragraph (a)(6)(ii) of this section, the \$2,000 of elective contributions for Employee E are taken into account in determining the ACP rather than the ADP. In addition, Plan V provides that the higher match rate is

not limited to 100% and applies only for a specified group of NHCEs. The only member of that group is Employee E. Under the plan provision, the higher match rate is a 400% match. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions of the eligible NHCEs (employees C through F) are shown in the following table:

| Employee | Compensation | Elective Contributions | Employee Contributions | Matching Contributions |
|----------|--------------|------------------------|------------------------|------------------------|
| C        | \$85,000     | \$12,000               | \$0                    | \$6,000                |
| D        | 70,000       | \$ 9,500               | \$0                    | \$4,750                |
| E        | 40,000       | \$ 2,000               | \$0                    | \$8,000                |
| F        | 10,000       | \$0                    | \$0                    | \$0                    |

(ii) If the entire matching contribution made on behalf of Employee E were taken into account under the ACP test, Plan V would satisfy the test, because the ACP for the NHCEs would be 9.71%  $(7.06\% + 6.79\% + 25.00\% + 0\%)/4$ . Because the ACP for the HCEs (12.11%) is less than 1.25 times what the ACP for the NHCEs would be, the plan would satisfy the requirements of section 401(m).

(iii) Pursuant to paragraph (a)(5)(ii) of this section, however, matching contributions for an eligible NHCE that exceed the greatest of 5% of compensation, the employee's elective deferrals and 2 times the product of the plan's representative matching rate and the employee's elective deferrals cannot be taken into account in applying the ACP test. The plan's representative matching rate is the lowest matching rate for

any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year who make elective contributions for the plan year. For Plan V, the group of NHCEs who make such contributions consists of Employees C, D and E. The matching rates for these three employees are 50%, 50% and 400% respectively. The lowest matching rate for a group of NHCEs that is at

least half of all the NHCEs who make elective contributions (or 2 NHCEs) is 50%. Because 400% is more than twice the plan's representative matching rate and the matching contributions exceed 5% of compensation, the full amount of matching contributions is not taken into account. Only \$2,000 of the matching contributions made on behalf of Employee E (matching contributions that do not exceed the greatest of 5% of compensation, the employee's elective deferrals, or the product of 100% (2 times the representative matching rate) and the employee's elective deferrals) satisfy the requirements of paragraph (a)(5)(ii) of this section and may be taken into account under the ACP test. Accordingly, the ACP for the NHCEs is  $5.96\% (7.06\% + 6.79\% + 10\% + 0\%)/4$  and the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

*Example 6.* (i) The facts are the same as *Example 2*, except that Plan V provides a QNEC equal to 13% of pay for Employee F that will be taken into account under the ACP test to the extent the contributions satisfy the requirements of paragraph (a)(6) of this section.

(ii) Pursuant to paragraph (a)(6)(v) of this section, a QNEC cannot be taken into account in determining an NHCE's ACR to the extent it exceeds the greater of 5% and the product of the employee's compensation and the plan's representative contribution rate. The plan's representative contribution rate is two times the lowest applicable contribution rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year. For Plan V, the applicable contribution rates for Employees C, D, E and F are 7.06%, 6.79%, 12.5% and 13% respectively. The lowest applicable contribution rate for a group of NHCEs that is at least half of all the NHCEs is 12.50% (the lowest applicable contribution rate for the group of NHCEs that consists of Employees E and F).

(iii) Under paragraph (a)(6)(v)(B) of this section, the plan's representative contribution rate is 2 times 12.50% or 25.00%. Accordingly, the QNECs for Employee F can be taken into account under the ACP test only to the extent they do not exceed 25.00% of compensation. In this case, all of the QNECs for Employee F may be taken into account under the ACP test.

(iv) After taking into account the QNECs for Employee F, the ACP for the NHCEs is  $9.84\% (7.06\% + 6.79\% + 12.50\% + 13\%)/4$ . Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m)(2) and paragraph (a)(1) of this section.

(b) *Correction of excess aggregate contributions*—(1) *Permissible correction methods*—(i) *In general.* A plan that provides for employee contributions or matching contributions does not fail to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan, uses either of the following correction methods—

(A) *Additional contributions.* The employer makes additional contributions that

are taken into account for the ACP test under this section that, in combination with the other contributions taken into account under this section, allow the plan to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess aggregate contributions distributed or forfeited.* Excess aggregate contributions are distributed or forfeited in accordance with paragraph (b)(2) of this section.

(ii) *Combination of correction methods.* A plan may provide for the use of either of the correction methods described in paragraph (b)(1)(i) of this section, may limit employee contributions or matching contributions in a manner that prevents excess aggregate contributions from being made, or may use a combination of these methods, to avoid or correct excess aggregate contributions. If a plan uses a combination of correction methods, any contributions made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction method in paragraph (b)(1)(i)(B) of this section.

(iii) *Exclusive means of correction.* A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than one described in paragraph (b)(1)(i) or (ii) of this section. Thus, excess aggregate contributions for a plan year may not be corrected by forfeiting vested matching contributions, distributing nonvested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Similarly, excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess aggregate contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5).

(2) *Correction through distribution*—(i) *General rule.* This paragraph (b)(2) contains the rules for correction of excess aggregate contributions through a distribution from the plan. Correction through a distribution generally involves a 4-step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess aggregate contributions that must be distributed under the plan. Sec-

ond, the plan must apportion the total amount of excess aggregate contributions among the HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess aggregate contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned contributions, together with allocable income (or forfeit the apportioned matching contributions, if forfeitable) in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions.

(ii) *Calculation of total amount to be distributed.* The following procedures must be used to determine the total amount of the excess aggregate contributions to be distributed—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE.* The amount of excess aggregate contributions attributable to an HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ACR to equal the highest permitted ACR under the plan. To calculate the highest permitted ACR under a plan, the ACR of the HCE with the highest ACR is reduced by the amount required to cause that HCE's ACR to equal the ACR of the HCE with the next highest ACR. If a lesser reduction would enable the plan to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction applies.

(B) *Determination of the total amount of excess aggregate contributions.* The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the plan would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess aggregate contributions for the plan year.

(C) *Satisfaction of ACP.* A plan satisfies this paragraph (b)(2)(ii)(C) if the plan would satisfy the requirements of paragraph (a)(1)(i) of this section if the ACR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess aggregate contributions among the HCEs.* The following procedures must be used in apportioning the total amount of excess aggregate contributions determined under paragraph (b)(2)(ii) of this section among the HCEs—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE.* The contributions with respect to the HCE with the highest dollar amount of contributions taken account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of contributions taken into account under this section for the HCE with the next highest dollar amount of such contributions. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess aggregate contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any HCE.* For purposes of this paragraph (b)(2)(iii), the contributions for an HCE who is an eligible employee in more than one plan of an employer to which matching contributions and employee contributions are made is determined by adding together all contributions otherwise taken into account in determining the ACR of the HCE under the rules of paragraph (a)(3)(ii) of this section. However, the amount of contributions apportioned with respect to an HCE must not exceed the amount of contributions taken into account under this section that were actually made on behalf of the HCE to the plan for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which employee contributions or matching contributions are made and whose ACR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount distributed under this paragraph (b)(2)(iii) will not exceed such contributions actually contributed to the plan for the plan year that are taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs.* The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess aggregate contributions have been apportioned.

(iv) *Income allocable to excess aggregate contributions—(A) General rule.* The income allocable to excess aggregate

contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess aggregate contributions are or will be credited with gain or loss for the gap period (*i.e.*, the period after the close of the plan year and prior to the distribution) if there was a total distribution of the account, the allocable gain or loss during that period.

(B) *Method of allocating income.* A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8). A plan will not fail to use a reasonable method for computing the income allocable to excess contributions merely because the income allocable to excess aggregate contributions is determined on a date that is no more than 7 days before the distribution.

(C) *Alternative method of allocating income for the plan year.* A plan may allocate income to excess aggregate contributions for the plan year by multiplying the income for the plan year allocable to employee contributions, matching contributions and other amounts taken into account under this section (including the contributions for the year), by a fraction, the numerator of which is the excess aggregate contributions for the employee for the plan year, and the denominator of which is the sum of the—

(1) Account balance attributable to employee contributions and matching contributions and other amounts taken into account under this section as of the beginning of the plan year; and

(2) Any additional such contributions for the plan year.

(D) *Safe harbor method of allocating gap period income.* A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess aggregate contributions for the gap period. Under this safe harbor method, income on excess aggregate contributions for the gap period is equal to 10% of the income allocable to excess aggregate contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number

of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) *Alternative method of allocating plan year and gap period income.* A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to that aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken into account for the plan year in determining the fraction that is multiplied by that income.

(F) *Allocable income for recharacterized elective contributions.* If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in §1.401(k)–2(b)(2)(iv).

(v) *Distribution and forfeiture.* Within 12 months after the close of the plan year in which the excess aggregate contribution arose, the plan must distribute to each HCE the contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section (and the allocable income) to the extent they are vested or forfeit such amounts, if forfeitable. Except as otherwise provided in this paragraph (b)(2)(v), a distribution of excess aggregate contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event



later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess aggregate contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) *Tax treatment of corrective distributions*—(A) *General rule.* Except as otherwise provided in this paragraph (b)(2)(vi), a corrective distribution of excess aggregate contributions (and income) that is made within 2½ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made more than 2½ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract (and is therefore not subject to tax under section 72) is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year. See also §1.402(c)-2, A-4 prohibiting rollover of distributions that are excess aggregate contributions.

(B) *Rule for de minimis distributions.* If the total amount of excess aggregate contributions determined under this paragraph (b)(2), and excess contributions determined under §1.401(k)-2(b)(2) distributed to a recipient under a plan for any plan year is less than \$100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made, except to the extent

the corrective distribution is a return of employee contributions.

(3) *Other rules*—(i) *No employee or spousal consent required.* A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(ii) *Treatment of corrective distributions and forfeited contributions as employer contributions.* Excess aggregate contributions (other than amounts attributable to employee contributions), including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(iii) *No reduction of required minimum distribution.* A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)-5, A-9(b).

(iv) *Partial correction.* Any distribution of less than the entire amount of excess aggregate contributions (and allocable income) is treated as a *pro rata* distribution of excess aggregate contributions and allocable income.

(v) *Matching contributions on excess contributions, excess deferrals and excess aggregate contributions*—(A) *Corrective distributions not permitted.* A matching contribution may not be distributed merely because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(B) *Coordination with section 401(a)(4).* A matching contribution is taken into account under section 401(a)(4) even if the match is distributed, unless the distributed contribution is an excess aggregate contribution. This requires that, after correction of excess aggregate contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section

410(b). See §1.401(a)(4)-4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if employee contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the HCEs' accounts. This is because the level of matching contributions will be higher for a group of employees that consists entirely of HCEs. Under section 411(a)(3)(G) and §1.411(a)-4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions and excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)-11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions. A plan is permitted to provide for which contributions are to be distributed to satisfy the ACP test so as to avoid discriminatory matching rates that would otherwise violate section 401(a)(4). For example, the plan may provide that unmatched employee contributions will be distributed before matched employee contributions.

(vi) *No requirement for recalculation.* If the distributions and forfeitures described in paragraph (b)(2) of this section are made, the employee contributions and matching contributions are treated as meeting the nondiscrimination test of section 401(m)(2) regardless of whether the ACP for the HCEs, if recalculated after the distributions and forfeitures, would satisfy section 401(m)(2).

(4) *Failure to timely correct*—(i) *Failure to correct within 2½ months after end of plan year.* If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess aggregate contributions. See section 4979 and §54.4979-1 of this chapter. Qualified nonelective contributions properly taken into account under paragraph (a)(6) of this section for a plan year may enable a plan to avoid having excess aggregate contributions, even if the contribu-

tions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year.* If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all

subsequent plan years in which the excess aggregate contributions remain in the trust.

(5) *Examples.* The following examples illustrate the application of this paragraph. See also §1.401(k)-2(b) for additional examples of the parallel correction rules applicable to cash or deferred arrangements. For purposes of these examples, none of the plans provide for catch-up contribu-

tions under section 414(v). The examples are as follows:

*Example 1.* (i) Employer L maintains a plan that provides for employee contributions and fully vested matching contributions. The plan provides that failures of the ACP test are corrected by distribution. In 2006, the ACP for the eligible NHCEs is 6%. Thus, the ACP for the eligible HCEs may not exceed 8%. The three HCEs who participate have the following compensation, contributions, and ACRs:

| Employee | Compensation | Employee contributions and matching contributions | Actual Contribution Ratio |
|----------|--------------|---|---------------------------|
| A        | 200,000      | 14,000  | 7%                        |
| B        | 150,000      | 13,500  | 9                         |
| C        | 100,000      | 12,000  | 12                        |
|          |              |   | Average 9.33%             |

(ii) The total amount of excess aggregate contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the matching and employee contributions of Employee C (the HCE with the highest ACR) is reduced by 3% of compensation (or \$3,000) in order to reduce the ACR of that HCE to 9%, which is the ACR of Employee B.

(iii) Because the ACP of the HCEs determined after the \$3,000 reduction still exceeds 8%, further reductions in matching contributions and employee contributions are necessary in order to reduce the ACP of the HCEs to 8%. The employee contributions and matching contributions for Employees B and C are reduced by an additional .5% of compensation or \$1,250 (\$750 and \$500 respectively). Because the ACP of the HCEs determined after the reductions now equals 8%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess aggregate contributions (\$4,250) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of matching contributions and employee contributions. Therefore, Em-

ployee A is apportioned \$500 (the amount required to cause A's matching contributions and employee contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(v) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance (\$3,750) of the total amount of excess aggregate contributions is apportioned equally among Employees A and B (\$1,500 to each, the amount required to cause their contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(vi) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance (\$750) of the total amount of excess aggregate contributions is apportioned equally among Employees A, B and C (\$250 to each, the amount required to allocate the total amount of excess aggregate contributions for the plan).

(vii) Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006

plan year, Employee A receives a corrective distribution of excess aggregate contributions equal to \$2,250 (\$500 + \$1,500 + \$250) and allocable income, Employee B receives a corrective distribution of \$250 and allocable income and Employee C receives a corrective distribution of \$1,750 (\$1,500 + \$250) and allocable income.

*Example 2.* (i) Employee D is the sole HCE who is eligible to participate in a cash or deferred arrangement maintained by Employer M. The plan that includes the arrangement, Plan X, permits employee contributions and provides a fully vested matching contribution equal to 50% of elective contributions. Plan X is a calendar year plan. Plan X corrects excess contributions by recharacterization and provides that failures of the ACP test are corrected by distribution. For the 2006 plan year, D's compensation is \$200,000, and D's elective contributions are \$15,000. The actual deferral percentages and actual contribution percentages for Employee D and the other eligible employees under Plan X are shown in the following table:

|            | Actual Deferral Percentage | Actual Contribution Percentage |
|------------|----------------------------|--------------------------------|
| Employee D | 7.5%                       | 3.75%                          |
| NHCEs      | 4%                         | 2%                             |

(ii) In February 2007, Employer M determines that D's actual deferral ratio must be reduced to 6%, or \$12,000, which requires a recharacterization of \$3,000 as an employee contribution. This increases D's actual contribution ratio to 5.25% (\$7,500 in matching contributions plus \$3,000 recharacterized as employee contributions, divided by \$200,000 in compensation). Since D's actual contribution ratio must be limited to 4% for Plan X to satisfy the actual contribution percentage test, Plan X must distribute 1.25% or \$2,500 of D's employee contributions and matching contributions together with allocable income. If \$2,500 in matching contributions and allocable income is distributed, this will correct the excess aggregate contributions and will not result in

a discriminatory rate of matching contributions. See *Example 8.*

*Example 3.* (i) The facts are the same as in *Example 2*, except that Employee D also had elective contributions under Plan Y, maintained by an employer unrelated to M. In January 2007, D requests and receives a distribution of \$1,200 in excess deferrals from Plan X. Pursuant to the terms of Plan X, D forfeits the \$600 match on the excess deferrals to correct a discriminatory rate of match.

(ii) The \$3,000 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the \$1,200 already distributed as an excess deferral, leaving \$1,800 to be recharacterized. See §1.401(k)-2(b)(4)(i)(A). D's actual contribution ratio is now 4.35% (\$7,500

in matching contributions plus \$1,800 in recharacterized contributions less \$600 forfeited matching contributions attributable to the excess deferrals, divided by \$200,000 in compensation).

(iii) The matching and employee contributions for Employee D must be reduced by .35% of compensation in order to reduce the ACP of the HCEs to 4%. The plan must provide for forfeiture of additional matching contributions to prevent a discriminatory rate of matching contributions. See *Example 8.*

*Example 4.* (i) The facts are the same as in *Example 3*, except that D does not request a distribution of excess deferrals until March 2007. Employer X has already recharacterized \$3,000 as employee contributions.

(ii) Under § 1.402(g)–1(e)(6), the amount of excess deferrals is reduced by the amount of excess contributions that are recharacterized. Because the amount recharacterized is greater than the excess deferrals, Plan X is neither required nor permitted to make a distribution of excess deferrals, and the recharacterization has corrected the excess deferrals.

*Example 5.* (i) For the 2006 plan year, Employee F defers \$10,000 under Plan M and \$6,000 under Plan N. Plans M and N, which have calendar plan years are maintained by unrelated employers. Plan M provides a fully vested, 100% matching contribution, does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k) and provides that excess contributions and excess aggregate contributions are corrected by distribution. Under Plan M, Employee F is allocated excess contributions of \$600 and excess aggregate contributions of \$1,600. Employee F timely requests and receives a distribution of the \$1,000 excess deferral from Plan M and, pursuant to the terms of Plan M, forfeits the corresponding \$1,000 matching contribution.

(ii) No distribution is required or permitted to correct the excess contributions because \$1,000 has been distributed by Plan M as excess deferrals. The distribution required to correct the excess aggregate contributions (after forfeiting the matching contribution) is \$600 (\$1,600 in excess aggregate contributions minus \$1,000 in forfeited matching contributions). If Employee F had corrected the excess deferrals of \$1,000 by withdrawing \$1,000 from Plan N, Plan M would have had to correct the \$600 excess contributions in Plan M by distributing \$600. Since Employee F then would have forfeited \$600 (instead of \$1,000) in matching contributions, Employee F would have had \$1,000 (\$1,600 in excess aggregate contributions minus \$600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan M. These would have been corrected by distributing an additional \$1,000 from Plan M.

*Example 6.* (i) Employee G is the sole HCE in a profit sharing plan under which the employer matches 100% of employee contributions up to 2% of compensation, and 50% of employee contributions up to the next 4% of compensation. For the 2008 plan year, Employee G has compensation of \$100,000 and makes a 7% employee contribution of \$7,000. Employee G receives a 4% matching contribution or \$4,000. Thus, Employee G's actual contribution ratio (ACR) is 11%. The actual contribution percentage for the NHCEs is 5%, and the employer determines that Employee G's ACR must be reduced to 7% to comply with the rules of section 401(m).

(ii) In this case, the plan satisfies the requirements of section 401(m) if it distributes the unmatched employee contributions of \$1,000, and \$2,000 of matched employee contributions with their related matches of \$1,000. This would leave Employee G with 4% employee contributions, and 3% matching contributions, for an ACR of 7%. Alternatively, the plan could distribute all matching contributions and satisfy this section. However, the plan could not distribute \$4,000 of Employee G's employee contributions without forfeiting the related matching contributions because this would result in a discriminatory rate of matching contributions. See also *Example 7.*

*Example 7.* (i) Employee H is an HCE in Employer X's profit sharing plan, which matches 100% of employee contributions up to 5% of compensation. The matching contribution is vested at the rate of 20% per year. In 2006, Employee H makes \$5,000 in employee contributions and receives \$5,000 of matching contributions. Employee H is 60% vested in the matching contributions at the end of the 2006 plan year. In February 2007, Employer X determines that Employee H has excess aggregate contributions of \$1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(ii) Employer X has two options available in distributing Employee H's excess aggregate contributions. The first option is to distribute \$600 of vested matching contributions and forfeit \$400 of nonvested matching contributions. These amounts are in proportion to Employee H's vested and nonvested interests in all matching contributions. The second option is to distribute \$1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iii) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50% must vest in each of the next 2 years.

(iv) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are forfeited because the effect is that matching contributions for HCEs vest more rapidly than those for NHCEs. See § 1.401(m)–2(b)(3)(v)(B).

*Example 8.* (i) Employer Y maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100%. After-tax employee contributions are permitted under the plan only for NHCEs and are matched at the same rate. No employees make excess deferrals. Employee J, an HCE, makes an \$8,000 elective contribution and receives an \$8,000 matching contribution.

(ii) Employer Y performs the actual deferral percentage (ADP) and the actual contribution percentage (ACP). To correct failures of the ADP and ACP tests, the plan distributes to A \$1,000 of excess contributions and \$500 of excess aggregate contributions. After the distributions, Employee J's contributions for the year are \$7,000 of elective contributions and \$7,500 of matching contributions. As a result, Employee J has received a higher effective rate of matching contributions than NHCEs (\$7,000 of elective contributions matched by \$7,500 is an effective matching rate of 107 percent). If this amount remains in Employee J's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only an HCE receives the higher matching contribution rate. The remaining \$500 matching contribution may be forfeited (but not distributed) under section 411(a)(3)(G), if the plan so provides. The plan could instead correct the discriminatory rate of matching contributions by making additional allocations to the accounts of NHCEs. See § 1.401(a)(4)–11(g)(3)(vii)(B) and (6), *Example 7.*

(c) *Additional rules for prior year testing method—(1) Rules for change in testing method.* A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in § 1.401(k)–2(c)(1)(ii). For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in § 1.401(m)–3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year.

(2) *Calculation of ACP under the prior year testing method for the first plan year—(i) Plans that are not successor plans.* If, for the first plan year of any plan (other than a successor plan), a plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ACP for the eligible NHCEs, or 3% as the ACP for eligible NHCEs, for applying the ACP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year for determining the ACP for the eligible NHCEs is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined.* For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for employee contributions or matching contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of § 1.410(b)–7) for a plan year if for such plan year the plan is aggregated under § 1.401(m)–1(b)(4) with any other plan that provides for employee or matching contributions in the prior year.

(iii) *Plans that are successor plans.* A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under another plan maintained by the employer in the prior year that provides for employee contributions or matching contributions. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ACP for the group of NHCEs for the

applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ACP and ADP test.* Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ACP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ADP test for that year. For example, a plan may use the prior year testing method for the ACP test and the current year testing method for its ADP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use —

(i) The recharacterization method of §1.401(k)–2(b)(3) to correct excess contributions for a plan year;

(ii) The rules of paragraph (a)(6)(ii) of this section to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph §1.401(k)–2(a)(6) to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage change—(i) In general.* A plan that uses the prior year testing method that experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ACP for the NHCEs for the plan year is the weighted average of the ACPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes.* If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ACP for the group of eligible NHCEs for the prior year under the plan is the ACP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions.* The following definitions apply for purposes of this paragraph (c)(4)—

(A) *Plan coverage change.* The term *plan coverage change* means a change in the group or groups of eligible employees under a plan on account of—

(1) The establishment or amendment of a plan;

(2) A plan merger or spinoff under section 414(l);

(3) A change in the way plans (within the meaning of §1.410(b)–7) are combined or separated for purposes of §1.401(m)–1(b)(4) (e.g., permissively aggregating plans not previously aggregated under §1.410(b)–7(d), or ceasing to permissively aggregate plans under §1.410(b)–7(d));

(4) A reclassification of a substantial group of employees that has the same effect as amending the plan (e.g., a transfer of a substantial group of employees from one division to another division); or

(5) A combination of any of paragraphs (c)(4)(iii)(A)(1) through (4) of this section.

(B) *Prior year subgroup.* The term *prior year subgroup* means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan that provides for employee contributions or matching contributions maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ACPs for the prior year subgroups.* The term *weighted average of the ACPs for the prior year subgroups* means the sum, for all prior year subgroups, of the adjusted ACPs for the plan year. The term *adjusted ACP with respect to a prior year subgroup* means the ACP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Example.* The following example illustrate the application of this paragraph (c)(4). See also §1.401(k)–2(c)(4) for examples of the parallel rules applicable to the ADP test. The example is as follows:

*Example.* (i) Employer B maintains two plans, Plan N and Plan P, each of which provides for employee contributions or matching contributions. The plans were not permissively aggregated under §1.410(b)–7(d) for the 2005 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 2005, and their ACP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 2005, and the ACP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively aggregated under §1.410(b)–7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 2006 testing year under §1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP). Therefore, the prior year ACP for the NHCEs under Plan NP for the 2006 testing year is the weighted average of the ACPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ACPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 2006 testing year, an employee is a member of a prior year subgroup if the employee was an NHCE of Employer B for the 2005 plan year, was an eligible employee for the 2005 plan year under any section 401(k) plan maintained by Employer B, and would have been an eligible employee in the 2005 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year. The NHCEs who were eligible employees under separate plans for the 2005 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP for the 2006 testing year: the 300 NHCEs who were eligible employees under Plan N for the 2005 plan year and the 100 NHCEs who were eligible employees under Plan P for the 2005 plan year.

(iv) The weighted average of the ACPs for the prior year subgroups is the sum of the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ACP for the NHCEs under Plan N for the prior year) x 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ACP for the NHCEs under Plan P for the prior year) x 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%. Thus, the prior year ACP for NHCEs under Plan NP for the 2006 testing year is 5.5% (the sum of adjusted ACPs for the prior year subgroups, 4.5% plus 1%).

#### §1.401(m)–3 Safe harbor requirements.

(a) *ACP test safe harbor.* Matching contributions under a plan satisfy the ACP safe harbor provisions of section

401(m)(11) for a plan year if the plan satisfies the safe harbor contribution requirement of paragraphs (b) or (c) of this section for the plan year, the limitations on matching contributions of paragraph (d) of this section, the notice requirement of paragraph (e) of this section, the plan year requirements of paragraph (f) of this section, and the additional rules of paragraphs (g), (h) and (j) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraphs (b) and (c) of this section must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) *Safe harbor nonelective contribution requirement.* A plan satisfies the safe harbor nonelective contribution requirement of this paragraph (b) if it satisfies the safe harbor nonelective contribution requirement of §1.401(k)-3(b).

(c) *Safe harbor matching contribution requirement.* A plan satisfies the safe harbor matching contribution requirement of this paragraph (c) if it satisfies the safe harbor matching contribution requirement of §1.401(k)-3(c).

(d) *Limitation on contributions—(1) General rule.* A plan that provides for matching contributions meets the requirements of this section only if it satisfies the limitations on contributions set forth in this paragraph (d).

(2) *Matching rate must not increase.* A plan that provides for matching contributions meets the requirements of this paragraph (d) only if the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective deferrals and employee contributions, does not increase as the amount of an employee's elective deferrals and employee contributions increases.

(3) *Limit on matching contributions.* A plan that provides for matching contributions satisfies the requirements of this section only if—

(i) Matching contributions are not made with respect to elective deferrals or employee contributions that exceed 6% of the employee's safe harbor compensation (within the meaning of §1.401(k)-3(b)(2)); and

(ii) Matching contributions that are discretionary do not exceed 4% of the employee's safe harbor compensation.

(4) *Limitation on rate of match.* A plan meets the requirements of this section only if the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) for that plan year is no greater than the ratio of matching contributions to elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) that would apply with respect to any NHCE for whom the elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) are the same percentage of safe harbor compensation. An employee is taken into account for purposes of this paragraph (d)(4) if the employee is an eligible employee under the cash or deferred arrangement with respect to which the contributions required by paragraph (b) or (c) of this section are being made for a plan year. A plan will not fail to satisfy this paragraph (d)(4) merely because the plan provides that matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that matching contributions with respect to any elective deferrals or employee contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(5) *HCEs participating in multiple plans.* The rules of section 401(m)(2)(B) and §1.401(m)-2(a)(3)(ii) apply for purposes of determining the rate of matching contributions under paragraph (d)(4) of this section. However, a plan will not fail to satisfy the safe harbor matching contribution requirements of this section merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that—

(i) The HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and

(ii) The period used to determine compensation for purposes of determining matching contributions under each such

plan is limited to periods when the HCE participated in the plan.

(6) *Permissible restrictions on elective deferrals by NHCEs—(i) General rule.* A plan does not satisfy the safe harbor requirements of this section, if elective deferrals or employee contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (d)(6).

(ii) *Restrictions on election periods.* A plan may limit the frequency and duration of periods in which eligible employees may make or change contribution elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (e) of this section) to make or change a contribution election for the plan year. For purposes of this section, a 30-day period is deemed to be a reasonable period to make or change a contribution election.

(iii) *Restrictions on amount of contributions.* A plan is permitted to limit the amount of contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (d)(6)(v) of this section) to make contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of contributions. However, a plan may require eligible employees to make contribution elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred.* A plan may limit the types of compensation that may be deferred or contributed by an eligible employee under a plan, provided that each eligible NHCE is permitted to make contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)-1(d)(2). Thus, the definition of compensation from which contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)-1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code.* A plan may

limit the amount of contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make contributions has been suspended for 6 months in accordance with §1.401(k)-1(d)(3)(iv)(E).

(e) *Notice requirement.* A plan satisfies the notice requirement of this paragraph (e) if it satisfies the notice requirement of §1.401(k)-3(d).

(f) *Plan year requirement—(1) General rule.* Except as provided in this paragraph (f) or in paragraph (g) of this section, a plan will fail to satisfy the requirements of section 401(m)(11) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of that plan year and remain in effect for an entire 12-month plan year. In addition, except as provided in paragraph (h) of this section, a plan which includes provisions that satisfy the rules of this section will not satisfy the requirements of §1.401(m)-1(b) if it is amended to change such provisions for that plan year. Moreover, if, as described in paragraph (j)(4) of this section, safe harbor matching or non-elective contributions will be made to another plan for a plan year, provisions under that other plan specifying that the safe harbor contributions will be made and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) *Initial plan year.* A newly established plan (other than a successor plan within the meaning of §1.401(m)-2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (f) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a plan will not fail to satisfy the requirements of this paragraph (f) for the first plan year in which matching contributions are provided under the plan provided that—

(i) The plan is not a successor plan; and

(ii) The amendment providing for matching contributions is made effective at the same time as the adoption of a cash

or deferred arrangement that satisfies the requirements of §1.401(k)-3, taking into account the rules of §1.401(k)-3(e)(2).

(3) *Change of plan year.* A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section (determined without regard to paragraph (h) of this section) for the immediately following plan year or for the immediately following 12 months if the immediately following plan year is less than 12 months.

(4) *Final plan year.* A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the final plan year is less than 12 months, provided that the plan satisfies the requirement of this section through the date of termination and either—

(i) The plan would satisfy the requirements of paragraph (h) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship, comparable to a substantial business hardship described in section 412(d).

(g) *Plan amendments adopting non-elective safe harbor contributions.* Notwithstanding paragraph (f)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section, effective as of the first day of the plan year, using non-elective contributions under paragraph (b) of this section if the plan satisfies the requirements of §1.401(k)-3(f).

(h) *Permissible reduction or suspension of safe harbor matching contributions—(1) General rule.* A plan that

provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(m)(2) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective deferrals and, if applicable, employee contributions provided—

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (h)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (h)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ACP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(m)-2(a)(1)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (h)) with respect to amounts deferred through the effective date of the amendment.

(2) *Notice of suspension requirement.* The notice of suspension requirement of this paragraph (h)(2) is satisfied if each eligible employee is given notice that satisfies the requirements of §1.401(k)-3(g)(2).

(i) [Reserved].

(j) *Other rules—(1) Contributions taken into account.* A contribution is taken into account for purposes of this section for a plan year under the same rules as §1.401(k)-3(h)(1).

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests.* A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4) under the same rules as §1.401(k)-3(h)(2).

(3) *Early participation rules.* Section 401(m)(5)(C) and §1.401(m)-2(a)(1)(iii)(A) which provide an alternative nondiscrimination rule for certain plans that provide for early participation, does not apply for purposes of section 401(m)(11) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan.* Safe harbor matching or non-elective contributions may be made to another defined contribution plan under the same rules as §1.401(k)-3(h)(4). Consequently, each NHCE under the plan providing for matching contributions must be eligible under the same conditions under the other defined contribution plan and the plan to which the contributions are made must have the same plan year as the plan providing for matching contributions.

(5) *Contributions used only once.* Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

(6) *Plan must satisfy ACP with respect to employee contributions.* If the plan provides for employee contributions, in addition to satisfying the requirements of this section, it must also satisfy the ACP test of §1.401(m)-2. See §1.401(m)-2(a)(5)(iv) for special rules under which the ACP test is permitted to be performed disregarding some or all matching when this section is satisfied with respect to the matching contributions.

*§1.401(m)-4 Special rules for mergers, acquisitions and similar events.*

[Reserved].

*§1.401(m)-5 Definitions.*

Unless otherwise provided, the definitions of this section govern for purposes of section 401(m) and the regulations thereunder.

*Actual contribution percentage (ACP).* *Actual contribution percentage* or *ACP* means the ACP of the group

of eligible employees as defined in §1.401(m)-2(a)(2)(i).

*Actual contribution percentage (ACP) test.* *Actual contribution percentage test* or *ACP test* means the test described in §1.401(m)-2(a)(1).

*Actual contribution ratio (ACR).* *Actual contribution ratio* or *ACR* means the ACR of an eligible employee as defined in §1.401(m)-2(a)(3).

*Actual deferral percentage (ADP) test.* *Actual deferral percentage test* or *ADP test* means the test described in §1.401(k)-2(a)(1).

*Compensation.* *Compensation* means compensation as defined in section 414(s) and §1.414(s)-1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. See also section 401(a)(17) and §1.401(a)(17)-1(c)(1). For this purpose, in case of an HCE whose ACR is determined under §1.401(m)-2(a)(3)(ii), period of participation includes periods under another plan for which matching contributions or employee contributions are aggregated under §1.401(m)-2(a)(3)(ii).

*Current year testing method.* *Current year testing method* means the testing method under which the applicable year is the current plan year, as described in §1.401(k)-2(a)(2)(ii) or §1.401(m)-2(a)(2)(ii).

*Elective contributions.* *Elective contributions* means elective contributions as defined in §1.401(k)-6.

*Elective deferrals.* *Elective deferrals* means elective deferrals described in section 402(g)(3).

*Eligible employee—(1) General rule.* *Eligible employee* means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for all or a portion of the plan year. For

example, if an employee must perform purely ministerial or mechanical acts (e.g., formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs these acts.

(2) *Conditions on eligibility.* An employee who is unable to make employee contributions or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (e.g., satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make employee contributions or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) *Certain one-time elections.* An employee is not an eligible employee merely because the employee, no later than the employee's first becoming eligible under any plan or arrangement described in section 219(g)(5)(A) and providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee in fact does elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan or arrangement maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. In no event is an election made after December 23, 1994, treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan or arrangement

(whether or not terminated) of the employer.

*Eligible HCE.* *Eligible HCE* means an eligible employee who is an HCE.

*Eligible NHCE.* *Eligible NHCE* means an eligible employee who is not an HCE.

*Employee.* *Employee* means an employee within the meaning of §1.410(b)-9.

*Employee contributions.* *Employee contributions* means employee contributions as defined in §1.401(m)-1(a)(3).

*Employee stock ownership plan (ESOP).* *Employee stock ownership plan* or *ESOP* means the portion of a plan that is an ESOP within the meaning of §1.410(b)-7(c)(2).

*Employer.* *Employer* means an employer within the meaning of §1.410(b)-9.

*Excess aggregate contributions.* *Excess aggregate contributions* means, with respect to a plan year, the amount of excess aggregate contributions apportioned to an HCE under §1.401(m)-2(b)(2)(iii).

*Excess contributions.* *Excess contributions* means with respect to a plan year, the amount of excess contributions apportioned to an HCE under §1.401(k)-2(b)(2)(iii).

*Excess deferrals.* *Excess deferrals* means excess deferrals as defined in §1.402(g)-1(e)(3).

*Highly compensated employee (HCE).* *Highly compensated employee* or *HCE* has the meaning provided in section 414(q).

*Matching contributions.* *Matching contribution* is defined in §1.401(m)-1(a)(2).

*Nonelective contributions.* *Nonelective contributions* means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

*Non-employee stock ownership plan (non-ESOP).* *Non-employee stock ownership plan* or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)-7(c)(2).

*Non-highly compensated employee (NHCE).* *Non-highly compensated employee* or *NHCE* means an employee who is not an HCE.

*Plan.* *Plan* means plan as defined in §1.401(m)-1(b)(4).

*Prior year testing method.* *Prior year testing method* means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)-2(a)(2)(ii) or 1.401(m)-2(a)(2)(ii).

*Qualified matching contributions (QMAC).* *Qualified matching contributions* or *QMAC* means matching contributions that satisfy the requirements of §1.401(k)-1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account as elective contributions under §1.401(k)-2(a)(6). See also §1.401(k)-2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it

is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

*Qualified nonelective contributions (QNEC).* *Qualified nonelective contributions* or *QNEC* means employer contributions, other than elective contributions or matching contributions, that satisfy the requirements of §1.401(k)-1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)-2(a)(6) or the ADP test under §1.401(m)-2(a)(6).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7808.

Par. 7. In §602.101, paragraph (b) is revised by removing the entries for “1.401(k)-1” and adding a new entry in numerical order in the table to read, in part, as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*

| CFR part or section where identified and described | Current OMB Control No. |
|--|-------------------------|
| * * * * *  |                         |
| 1.401(k)-1<br>* * * * *                            | 1545-1669               |

Par. 8. In §602.101, paragraph (b) is amended by adding entries in numerical order to the table to read, in part, as follows:

§602.101 OMB Control numbers.

\* \* \* \* \*

(b) \* \* \*



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CFR part or section where  
identified and described

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Current OMB  
Control No.

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\* \* \* \* \*

1.401(k)-2 ..... 1545-1669  
\* \* \* \* \*

1.401(k)-3 ..... 1545-1669  
\* \* \* \* \*

1.401(k)-4 ..... 1545-1669  
\* \* \* \* \*

1.401(k)-3 ..... 1545-1699  
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Mark E. Matthews,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved December 15, 2004.

Gregory F. Jenner,  
*Acting Assistant Secretary of the Treasury.*

(Filed by the Office of the Federal Register on December 28,  
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