Employee Benefit Plans

Explanation No. 12

Section 401(k) Requirements

The purpose of Worksheet Number 12 (Form 9002) and this explanation is to identify major problems that relate to plans that include a cash or deferred arrangement.

This explanation, along with Worksheet #12 and Attachment #12 with the same revision date as this explanation, reflects the rules for 401(k) plans in plan years beginning on and after January 1, 2006. Thus, they reflect the final section 401(k) and (m) regulations, published in the Federal Register on December 29, 2004; catch-up contributions under section 414(v) and the qualification rules for Roth elective contributions described in section 402A.

A plan must operate in accordance with the final section 401(k) and (m) regulations that were published on December 29, 2004, by the first plan year beginning after December 31, 2005. However, a plan may be amended to apply these regulations earlier, beginning with any plan year ending after December 29, 2004, provided the plan applies all the rules in these regulations as of such date.

Section 401(k) of the Internal Revenue Code establishes the requirements that must be satisfied in order to permit the elective deferral of compensation on a pre-tax basis under a qualified plan. Worksheet Number 12 and this explanation are to be used to determine whether the provisions of a CODA under a plan satisfy the requirements of section 401(k).

Generally, a “Yes” answer to a question on the worksheet indicates a favorable conclusion, while a “No” answer signals a problem concerning qualification of the arrangement and/or plan. This rule may be altered by specific instructions for a given question. Please explain any “No” answer in the space provided on the worksheet.

The sections cited at the end of each paragraph of this explanation are, except as otherwise noted, to the Internal Revenue Code and the final Income Tax Regulations.

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The technical principles in this publication may be changed by future regulations or guidelines.

I. Applicability

Section 401(k) of the Code is the exclusive method of deferring compensation on an elective, pre-tax basis under a qualified plan. This section sets forth the requirements that a cash or deferred arrangement (CODA) must satisfy in order to be a qualified arrangement. These requirements include a special nondiscrimination test called the actual deferral percentage or ADP test. If the requirements of section 401(k) are met, contributions under a qualified plan that are made pursuant to an employee's deferral election are not taxed to the employee at the time contributed to the plan or when the amounts would have been available to the employee in cash had there been no deferral election, but are treated as employer contributions to the plan. Roth elective contributions (sometimes called designated Roth contributions), which are permitted in 401(k) plans beginning in 2006, also must meet the requirements applicable to traditional elective contributions (pre-tax elective contributions), but Roth elective contributions are not excluded from the employee's gross income.

401(k), 402(e)(3),402A
1.401(k)-1(a)(4)

a. Existence of a Cash or Deferred Arrangement (CODA)
A plan includes a CODA if it includes any arrangement under which an eligible employee may make a cash or deferred election to have the employer either contribute an amount to the plan's trust or to pay the amount to the employee in cash or some other taxable benefit. For example, a CODA would include an arrangement that permits an employee to elect to receive cash or to accrue a benefit under a defined benefit plan. (However, see I.b. and V.c., below.) A cash or deferred election is an election (or a modification of an earlier election) that is made at any time permitted by the plan with respect to cash or other amounts that are not currently available to the employee and that are not designated or treated as after-tax employee contributions at the time of deferral or contribution.

401(k)(2)(A)
1.401(k)-1(a)(2) and (3)

b. Plans Which May Include a CODA
CODAs are allowed in profit-sharing plans, stock bonus plans, rural cooperative plans (as defined in section 401(k)(7)), and money purchase pension plans that on June 27, 1974 included a CODA (pre-ERISA money purchase plans defined in section 401(k)(6)). A plan which is not described in one of these categories and which includes a CODA will not satisfy section 401(a). A CODA that is maintained by a state or local government will not be a qualified CODA if the CODA is adopted after May 6, 1986. CODAs adopted by state and local governments on or before this date will be qualified CODAs if the other requirements of section 401(k) are met. A CODA adopted by a tax-exempt organization after July 1, 1986 and before January 1, 1997 will not be a qualified CODA.

401(k)(1), (4)(B), (6) and (7)
1.401(k)-1(a)(1) and (e)(4)

II. Contributions

a. An election by the participant to defer compensation under a CODA must be in effect before such a deferral may be made and generally the contribution must be made after the performance of services with respect to which the contribution is made. Elective deferral agreements may be modified at any time permitted by the plan. A one-time irrevocable election to have a specified amount (including no amount) contributed to a plan, made at the time first eligible to participate in a plan, does not constitute a cash or deferred election. Any cash or deferred election must be made before the time at which the amount is currently available to the employee, i.e., before the employee may receive the amount. A cash or deferred election does not include an election to defer amounts that have become currently available to the employee before the CODA is adopted. A CODA will not be qualified unless the amount the employee may defer is available to the employee in cash. For example, a CODA which allows an employee to receive a taxable benefit (other than cash) or to have a contribution made to the plan will not be a qualified CODA. A cash or deferred election will not fail to be made under a qualified CODA merely because, when an employee fails to make an affirmative election with respect to an amount of compensation, that amount is contributed on the employee's behalf (either as Roth or pre-tax elective contributions or a combination of both, as specified in the plan) to a trust (a so-called "automatic enrollment" feature), provided that the employee had an effective opportunity to elect to receive that amount in cash. A plan that permits Roth elective contributions (after 2005) must first allow pre-tax elective contributions. In other words, a plan cannot allow just Roth elective contributions. Roth elective contributions must be irrevocably designated as such by the employee before they go into the plan and must be treated by the employer as includible in the employee's wages. Roth elective contributions are treated the same as pre-tax elective contributions for all purposes under the plan, but special rollover rules apply to these amounts.

401(k)(2)(A), 402A
1.401(k)-1(a)(3), (e)(2) and (f)

b. Generally, a plan must separately account for elective contributions (i.e., employer contributions resulting from an employee's election to defer under a qualified CODA), and Roth elective contributions must be kept separate from pre-tax elective contributions, as well as from all other contributions. This does not mean that the plan must have actual separate accounts but that the plan must have some means of allocating and determining gains, losses, withdrawals, etc., separately for each type of contribution. Strict accounting with respect to Roth elective contributions is essential because all qualified distributions from Roth elective contribution accounts are completely tax-free. The employer must keep track of all amounts going into and out of each employee's Roth elective contribution account. (See explanations IV. and VII.a. and b.)

1.401(k)-1(e)(3)and (f)(2)

c. Section 401(a)(30) requires a plan that accepts elective contributions to provide that a participant's elective contributions for a calendar year under the plan and all other plans, contracts and arrangements of the employer will not exceed the limit imposed by section 402(g) of the Code for the calendar year with or within which the participant's taxable year begins. However, to avoid disqualification, the plan may provide for the distribution of excess deferrals made under the plan or plans of the same employer (or related employers) by no later than the first April 15 following the close of the year in which the excess arose. The limit under section 402(g) is $10,500 for taxable years beginning in 2000 and 2001, increasing to $11,000 for taxable years beginning in 2002 and increasing by $1,000 for each year thereafter up to $15,000 for taxable years beginning in 2006 and later years. After 2006, the $15,000 limit will be adjusted for cost-of-living increases under section 402(g)(4). Any such adjustments will be in multiples of $500. For taxable years beginning in 2002, the limit under section 402(g) is increased by the amount of catch-up contributions permitted under section 414(v) for participants aged 50 or over by the end of the taxable year. The dollar limit on catch-up contributions is $1,000 for taxable years beginning in 2002, increasing by $1,000 for each year thereafter up to $5,000 for taxable years beginning in 2006 and later years. After 2006, the $5,000 limit will be adjusted for cost-of-living increases under section 414(v)(2)(C). Any such adjustments will be in multiples of $500. Different limits apply to catch-up contributions under SIMPLE 401(k) plans. Catch-up contributions are elective contributions that exceed a statutory or plan limit (in most cases, the 402(g) limit or the ADP limit) but are nevertheless permitted by participants aged 50 and over, provided they have the compensation to defer. Catch-up contributions are treated the same as other elective contributions under the plan but they are not counted in the ADP test nor as a key employee contribution when determining the contribution required for non-key employees in top-heavy years under section 416.

401(a)(30), 402(g) and 414(v)
1.402(g)-1(e)
1.414(v)-1

III. Coverage and Participation

a. Employees eligible under a CODA must satisfy the percentage test of section 410(b)(1)(A), the ratio test of section 410(b)(1)(B), or the average benefits test of section 410(b)(1)(C). For purposes of the coverage requirements, all eligible employees under the CODA are treated as benefiting under the CODA. The term "eligible employee" means any employee who is directly or indirectly eligible to make a cash or deferred election, including an employee who has reached the limit on annual additions under section 415 and an employee whose eligibility to make an election has been suspended because of a distribution, loan or an election not to participate in the plan. However, an employee who makes a one-time election, upon first becoming eligible, not to defer for the duration of employment is not considered an eligible employee. For special rules that apply if an employer elects to apply section 410(b)(4)(B) relating to the exclusion of certain employees, see Part V, Line b. (i). Finally, for purposes of determining if an arrangement satisfies coverage, the aggregation rules discussed under Discrimination apply. (See Part V.) The application for determination should include a demonstration that the CODA satisfies the coverage requirements.

401(k)(3)(A)(i)
1.401(k)-1(b)(1) and (g)(4)

b. A qualified CODA may not impose an age or service requirement for participation in the CODA which requires more than one year of service or a minimum age greater than 21.

401(k)(2)(D)

IV. Vesting

a. Section 401(k)(2)(C) of the Code requires that elective contributions and other contributions that may be treated as elective contributions, as described in V. and VI., below, must be nonforfeitable when made to the plan. In order for a contribution to be nonforfeitable each participant, regardless of age or service, must immediately be vested in his or her elective contributions.

401(k)(2)(C)
1.401(k)-1(c)

V. Discrimination

a. (i) and (ii). A plan that includes a CODA must provide that the actual deferral percentage (ADP) test set forth in section 401(k)(3)(A) will be met. Plans of state and local governments are treated as satisfying this test, and special rules apply in the case of certain collectively bargained plans. Section 401(k)(3) is the exclusive nondiscrimination test applicable to the amount of elective contributions under a qualified CODA. A plan with elective contributions under a qualified CODA will satisfy section 401(a)(4) only if the amount of elective contributions satisfies section 401(k)(3). For calendar years beginning after December 31, 1996, a plan subject to section 401(k) is deemed to satisfy the ADP test if it contains, and complies in operation with, "SIMPLE" provisions or, for plan years after 12/31/98, "Safe Harbor CODA" provisions. SIMPLE provisions are described in sections 401(k)(11) and 401(m)(10) of the Code. (See Part IX.) Safe Harbor CODA provisions are described in sections 401(k)(12) and 401(m)(11). (See Part X.) For plan years beginning after December 31, 1996, the ADP test compares the average of the actual amounts deferred for the plan year, as a percentage of compensation, by the eligible highly compensated employees to the average of the actual amounts deferred, again as a percentage of compensation, by the eligible non-highly compensated employees for the prior plan year. "Catch-up contributions" described in section 414(v) are ignored for purposes of the ADP test. (See Part II.c.) The plan year being tested is sometimes referred to as the "testing year," and this method of performing the ADP test, the "prior year testing method." (See explanation VIII.c. for the definition of compensation.) The ADP test is computed by first separately calculating the actual deferral ratios ("ADRs") of each eligible employee and then averaging the ratios of all eligible employees in the highly compensated and non-highly compensated groups. The individual ratios as well as the group percentages must be calculated to the nearest one-hundredth of one percent. The average percentage deferred by the eligible highly compensated employees may not exceed the greater of:

1) 1.25 times the average of the deferral ratios for the eligible non-highly compensated employees for the prior plan year; or,

2) the lesser of a) two times the average of the deferral ratios for the eligible nonhighly compensated employees for the prior plan year, or b) two plus the average of the deferral ratios for the eligible non-highly compensated employees for the prior plan year.

Example:

Employee	Compensation	Deferral	ADR	ADP
A	$100,000	$6,500	6.50%	
B	$90,000	$4,000	4.44%	5.31%
C	$80,000	$4,000	5.00%	
D	$20,000	$0	0.00%	
E	$10,000	$0	0.00%	3.33%
F	$10,000	$1,000	10.00%	

(D, E, and F are non-highly compensated employees, and the figures shown for them in this table are for the prior plan year.

All employees are under age 50.) Under the ADP test, the employer must compare the ADP of the eligible highly compensated employees (A, B, and C) to the ADP of the eligible non-highly compensated employees for the prior plan year, using the formulas above to determine whether 1) or 2) is met.

1) 3.33 x 1.25=4.16. Since 5.31 is greater than 4.16, Test 1) is not met.

2) 3.33 x 2=6.66, 3.33 + 2=5.33; 5.33 is the lesser of the two. Since 5.31 is less than 5.33, Test 2) is met and the plan passes the ADP test.

For the first plan year a plan is subject to section 401(k), the employer can elect, by so providing in the plan, to use either 3 percent as the ADP of the non-highly compensated employees or the ADP for that first plan year. This election is not available if the plan is a "successor plan," i.e., at least half the eligible employees under the plan were eligible under another section 401(k) plan of the employer in the prior year.

If elected by the employer, by so providing in the plan, the ADP test can be applied by comparing the current plan year's ADP for highly compensated employees with the current, rather than the prior, plan year's ADP for non-highly compensated employees. This method of ADP testing is called the "current year testing method." Note that the plan must specify whether the prior year or the current year testing method will be used. If the employer has elected to use the current year testing method, switching to prior year testing can only be done if the plan meets the requirements for changing to prior year testing set forth in regulations section 1.401(k)-2(c)(1). Generally, a plan can switch from current year testing to prior year testing only if 1) the employer has been involved in a merger, acquisition or similar transaction, and as a result, plans using different testing methods are maintained; and 2) the plan has used current year testing for the past 5 years. A plan can be amended anytime to use the current year testing method for a future plan year.

The plan must provide that it will meet the ADP test (unless it contains SIMPLE provisions or Safe Harbor CODA provisions). However, in lieu of stating the ADP test, the plan may incorporate by reference the provisions of section 401(k)(3) and the regulations thereunder. The following discussion summarizes the principal requirements of these regulations. A plan that sets forth the ADP test in lieu of incorporating it by reference must describe the test in a manner which satisfies these requirements, including whether it is using the current or prior year testing method and, if using the prior year testing method, whether 3 percent or the first plan year's ADP is to be used for the non-highly compensated employees for the first testing year. (Also see VII.c. regarding the effect of distributions of excess deferrals on the calculation of the ADP test.)

For plan years beginning before 2002, plans had to also satisfy the multiple use limitation of former Code section 401(m)(9). This limitation applied if a highly compensated employee participates in an employer's CODA that is subject to section 401(k) as well as in its plan subject to section 401(m). A plan is subject to the requirements of section 401(m) if it provides for employee or matching contributions. (See Worksheet #11.) However, the multiple use limitation did not apply if a plan contained SIMPLE provisions or satisfied the ADP test safe harbor.

401(k)(3)(A)(ii), (3)(G), (11) and (12) and 414(v)(3)(B)
1.401(k)-1(a)(4)(iv), (b), (e)(7), -2(c), -3 and -4

b. (i) Eligible Employees
The actual deferral ratios of all eligible employees must be taken into account for the ADP test. For this purpose, the term "eligible employee" has the same meaning as discussed under Coverage and Participation (see explanation III.a.). If an eligible employee has not made an elective deferral, the deferral ratio is zero and must be included in the ADP of the applicable group (either the highly compensated group or the non-highly compensated group).

Some plans have tried to base the ADP test only upon participants, rather than eligible employees. They then define "participant" as any employee who chooses to make an elective deferral. This definition inflates the deferral percentage by ignoring all the employees who would otherwise be counted in the ADP test as having deferral ratios of zero percent. This is not a permissible definition of participant for the purposes of calculating the deferral percentage.

1.401(k)-1(b)(1) and -2

For plan years beginning after 12-31-98, if an employer elects to apply section 410(b)(4)(B) (relating to exclusion of employees not meeting the statutory minimum age and service requirements), in determining whether a CODA meets section 410(b)(1) the plan may provide that, in determining whether the CODA meets the ADP test, all eligible employees (other than HCEs) who have not met the minimum age and service requirements of section 410(a)(1)(A) (age 21 and 1 year of service) are excluded.

401(k)(3)(F)
1.401(k)-2(a)(1)(iii)

(ii) and (iii) Contributions Taken Into Account
In running the ADP test for a plan year, an elective contribution is to be taken into account only if it relates to compensation that either (a) would have been received by the employee in the plan year but for the deferral election, or (b) if the plan specifically provides, is attributable to services performed by the employee in the plan year and would have been received by the employee within 2½ months after the close of the plan year but for the deferral election. In addition, an elective contribution is to be taken into account under the ADP test for a plan year only if it is allocated to the employee as of a date within the plan year. An elective contribution is considered allocated as of a date within the plan year if the allocation is not contingent on the performance of services after that date and the contribution is actually paid to the trust by the last day of the 12th month after the end of the plan year. (Note that Department of Labor regulations at 29 CFR 2510.3-102 require that money withheld from an employee's paycheck be deposited into the plan as of the earliest date such money can be separated from the employer's general assets but not later than the 15th business day after the month the money was withheld.) An elective contribution which does not relate to the current plan year's compensation or which is not allocated during the plan year to which it relates is not eligible to be tested under the ADP test. Instead, the contribution must satisfy section 401(a)(4) for the plan year in which it is allocated as if it were the only employer contribution for that year.

1.401(k)-2(a)(4) and (5)

Under certain circumstances, an employer may treat certain non-elective contributions (i.e., qualified non-elective contributions or QNECs) and certain matching contributions (i.e., qualified matching contributions or QMACs) as elective contributions for purposes of the ADP test. If the terms of the plan

provide for this, then Part VI. of the worksheet should also be completed.
1.401(k)-2(a)(6)

(iv) and (v) Aggregation
If an employer maintains more than one CODA, the following aggregation rules apply. When two or more plans are treated as a single plan for purposes of section 401(a)(4) or 410(b) (other than the average benefits test under section 410(b)(2)(A)(ii)), all CODAs included in such plans are treated as a single CODA for purposes of the ADP test as well as for the purposes of section 401(a)(4) and 410(b). Two or more CODAs may be permissively aggregated if the aggregated CODAs satisfy the ADP test. Plans may not be permissively aggregated unless they have the same plan year and use the same testing method (either all current or all prior). In this case the aggregated CODAs and the plans are treated as a single CODA and a single plan for purposes of sections 401(a)(4), 401(k) and 410(b). After the effective date of the final 401(k) and 401(m) regulations, an ESOP may be aggregated with a non-ESOP for purposes of the ADP (and ACP) test, only. Notwithstanding the foregoing, a plan covering collective bargaining unit employees may not be aggregated with one that does not cover such employees. In addition, the following single plans must be separated into component plans and tested separately: 1) plans which benefit employees covered by a collective bargaining agreement and employees covered under another, or no, collective bargaining agreement; 2) plans covering employees of two or more qualified separate lines of business (unless the special rule for employer-wide plans in section 1.414(r)-1(c)(2)(ii) of the regulations apply); and 3) plans covering employees of more than one employer not pursuant to a collective bargaining agreement. However, an employer may elect to treat two or more collective bargaining agreements as one collective bargaining agreement, so that employees covered under different collective bargaining agreements will be treated as if covered under a single plan. This election can only be made if the combinations are reasonable and reasonably consistent from year to year.

When plans are combined, or plan eligibility is changed, and the employer is using the prior year testing method, the ADP for non-highly compensated employees is the sum of the ADPs of the employer's plans these employees were in during the preceding year, with each such plan's preceding year ADP reduced to reflect the proportion of non-highly compensated employees from that plan in the present plan.

Example:
In Year 1, an employer had three plans subject to section 401(k), with the ADPs for non-highly compensated employees being 2, 3 and 4 percent. In Year 2, the plans are properly combined, resulting in one plan with 400 eligible non-highly compensated employees: 200 from the 2-percent plan and 100 from each of the other two plans. Using the prior year testing method for Year 2, the ADP is 2.75. [(2 X 200/400) + (3 X 100/400) + (4 X 100/400)=2.75]

Repeated plan amendments to inflate the ADP of highly compensated employees could cause the plan to fail the nondiscrimination requirement of Code section 401(k)(3), even if the ADP test is passed.

Elective contributions may not be used to satisfy minimum contributions or benefit requirements under section 416 or (except to the extent provided in section 401(k) or (m)) to enable any other plan to meet the requirements of section 401(a) or 410(b). (See explanation VI.)

Whenever a highly compensated employee is eligible under more than one CODA of the same employer, this employee's actual deferral ratio is calculated by treating all the CODAs as one CODA. Thus, in this situation, the highly compensated employee's actual deferral ratio will be the same under all CODAs in which he or she is eligible to participate. This rule does not apply to employees who are not highly compensated. Also, this rule does not apply in the case of contributions to plans that may not be aggregated (unless the reason they can't be aggregated is inconsistent testing methods (prior versus current year) or different plan years).

Note that a plan may not be restructured to satisfy the ADP test.
401(k)(3)
1.401(k)-1(b)(3), (4), -2(a)(3)(ii) and -2(c)(4)

(vi) Use of Relevant Plan Years
The plan must use the proper plan years when determining the ADRs of the highly compensated employees and of the non-highly compensated employees. As described in V.a., above, if the plan is using the prior year testing method, the ADP of highly compensated employees for a testing year is determined using current plan year (testing year) data while the ADP for non-highly compensated employees is determined using prior plan year data. Whether an eligible employee is in the highly compensated or non-highly compensated group, or both, is based on his or her status in the current and prior plan years. Similarly, if the plan is using the current year testing method, the ADPs of both highly compensated employees and non-highly compensated employees (and their identity as one or the other) for a testing year are determined using current plan year (testing year) data.
401(k)(3)

c. In addition to satisfying the ADP test, a plan that includes a qualified CODA must also satisfy section 401(a)(4) with respect to the availability of benefits, rights, and features under the plan, including the right to make each level of elective contributions. To satisfy this availability requirement, a benefit, right or feature must be available to a group of employees that satisfies section 410(b). Any limitation on the percentage of compensation (such as the definition of compensation subject to a deferral election) that may be deferred which favors highly compensated employees will cause both the CODA and the plan to fail to be qualified. A CODA may not be integrated with Social Security, although the underlying profit-sharing or stock bonus plan may be so integrated.

A plan that permits catch-up contributions under section 414(v) will not violate section 401(a)(4) (because some employees can defer more than others), provided the ability to make such contributions is universally available to employees (other than collectively bargained employees described in section 410(b)(3)) aged 50 and over. All elective deferral plans of the employer must be considered for this rule and "employer" is determined after the application of section 414(b), (c), (m) and (o). (See Part II.c. for more on catch-up contributions.)

A CODA will not be qualified if any other benefit is directly or indirectly conditioned on whether or not the employee chooses

to defer. Examples of such benefits are benefits under a defined benefit plan, non-elective employer contributions (other than matching contributions resulting from the deferral), plan loans, increases in salary and bonuses, and medical, dental, and vacation benefits.
414(v)
1.401(a)(4)-4 1.401(k)-1(a)(4)(iv) and (e)(6)
1.414(v)-1(e)

VI. QNECs and QMACs

Under certain circumstances, an employer may treat qualified non-elective contributions (QNECs) as elective contributions for purposes of the ADP test. QNECs are employer contributions, other than matching contributions, which are not subject to employee election, are fully vested when made to the plan, and are subject to the distribution restrictions that apply to elective contributions regardless of whether they are actually taken into account for the ADP test. A plan must provide a definite allocation formula for QNECs. An employer may also, under certain circumstances, treat certain matching contributions as elective contributions. Matching contributions that are eligible to be treated as elective contributions are referred to as qualified matching contributions (QMACs). A QMAC, like a QNEC, is fully vested when it is made to the plan and is subject to the distribution restrictions applicable to elective contributions regardless of whether it is actually taken into account for the ADP test. Matching contributions do not violate the “fully vested when made to the plan” requirement if they may be forfeited because the contributions on which they were based were excess deferrals, excess contributions, or excess aggregate contributions.

As of the effective date of the final section 401(k) and (m) regulations, the practice of targeting QNECs at non-highly compensated employees with the least salary (so-called “bottom-up leveling”) could result in some or all of such QNECs being ineligible for use in the ADP (or ACP) test.

A plan which provides for employee or matching contributions is subject to the requirements of section 401(m) of the Code. (See Worksheet #11.) Section 401(m) includes an actual contribution percentage (ACP) test which is identical to the ADP test except that employee and matching contributions are substituted for elective contributions. (However, QMACs that an employer takes into account for the ADP test are disregarded in performing the ACP test. Thus, the ACP test will not be relevant where there are no employee contributions and the only matching contributions are QMACs that are counted as elective contributions in the ADP test.) On the 401(m) side, the employer may, under certain circumstances, treat elective contributions under a CODA and/or QNECs as matching contributions for the ACP test.

If a plan switches from the current year testing method to the prior year testing method, regulations sections 1.401(k)-2(a)(6)(vi) and 1.401(m)-2(a)(6)(vi) limit the extent to which QNECs and QMACs may be taken into account in determining the NHCEs’ ADP or ACP for the prior year.

This part of the worksheet should be completed if the terms of the plan provide that QNECs and/or QMACs will be taken into account for the ADP test or if the plan provides that the employer will make additional QNECs or QMACs if necessary to satisfy the ADP test.

401(k)(3)(D), 401(k)(8)(E), 401(m)(3) and (m)(4)
1.401(k)-2(a)6) and -6
1.401(m)-2(a)(6) and -5

a. (i) QNECs and QMACs must be fully vested (but see above for instances of when QMACs may be forfeited) when made to the plan, without regard to the participant’s age and service and without regard to whether the contribution is actually taken into account for the ADP test. Thus, forfeitures cannot be used as QNECs or QMACs because such contributions were not fully vested when made to the plan.
401(k)(3)(D)
1.401(k)-6

(ii) QNECs and QMACs may be distributed only under circumstances that also permit the distribution of elective contributions. (See VII.a. and b.) However, for plan years beginning after 1988, amounts attributable to QNECs and QMACs may not be distributed on account of hardship, unless credited to the employee’s account as of a date specified in the plan which may be no later than December 31, 1988, or, if later, the end of the last plan year ending before July 1, 1989. Under the terms of the plan, QNECs and QMACs must be subject to these distribution limitations regardless of whether they are actually taken into account for the ADP test.
401(k)(3)(D)
1.401(k)-6)

b. If the plan provides that it will take QNECs and QMACs into account for purposes of the ADP test, it must limit the QNECs and QMACs that will be treated as elective contributions to those contributions that are made with respect to employees who are eligible employees under the CODA being tested. QNECs and QMACs cannot be used in an ADP test if they have already been used in an ACP test or another ADP test (e.g., in an ADP test in a plan that switches from current year testing to prior year testing) or have been used in a safe harbor CODA or a SIMPLE 401(k) plan. Furthermore, the plan must provide that such contributions will be treated as elective contributions only if the additional requirements described below and specified in section 1.401(k)-2(a)(6) of the regulations are satisfied.

The plan may incorporate these requirements by reference.

1. The non-elective contributions, including QNECs treated as elective contributions for the ADP test and QNECs treated as matching contributions for the ACP test, satisfy section 401(a)(4).

2. The non-elective contributions, excluding QNECs treated as elective contributions for the ADP test and QNECs treated as matching contributions for the ACP test, satisfy section 401(a)(4). (QNECs allocated to the accounts of NHCEs and HCEs for the same plan year are subject to the requirements of section 401(a)(4) for that plan year even if the plan is using the prior year testing method whereby the QNECs for the NHCEs and HCEs are taken into account for the ADP test in different years.)

3. The QNECs and QMACs are allocated to the employee within the relevant plan year and are actually paid to the trust on or before 12 months after the end of that plan year. (See explanation V.b.(iii) regarding when a contribution is considered allocated within a plan year for this purpose.)

The plan which treats QNECs and QMACs as elective contributions and the plan to which the QNECs and QMACs are made must have the same plan year and otherwise could be aggregated for purposes of ADP testing. Thus, QMACs made under a plan that uses current year testing could not be used in a CODA that uses prior year testing.

A QNEC that exceeds 5 percent of the non-highly compensated employee's compensation (10 percent in the case of Davis-Bacon-type plans) cannot be counted in the ADP test if it is greater than twice the lowest QNEC and QMAC percentage given to at least half the eligible non-highly compensated employees. A similar rule applies to matching contributions, including QMACs used in the ADP test.

Example:

> An employer has four non-highly compensated employees eligible for its CODA and they have compensation for the plan year of $1,000, $10,000, $20,000 and $50,000. If the employer makes a flat-dollar QNEC to these employees of $200, which as a percentage of compensation is 20%, 2%, 1% and 0.4%, respectively, no more than 5% of the $1,000 employee's QNEC can be used in the ADP test because the most that half these employees got was a 2% QNEC and twice 2% is only 4%. Prior to the final section 401(k) and (m) regulations, the full 20% could have been used to raise the ADP of the non-highly compensated employees.

401(k)(3)(D)
1.401(k)-2(a)(6)

VII. Distributions/Corrections

a. Elective contributions (and QNECs and QMACs), and the earnings attributable to such contributions, may only be distributed upon the earlier of death, disability, severance from employment or termination of the plan without establishment or maintenance of another defined contribution plan (other than an ESOP, a SEP, a SIMPLE IRA plan, a section 403(b) plan or a section 457 plan) that benefits 2 percent or more of the employees in the terminated plan. Distributions permitted upon plan termination must be in a lump sum. An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan.

In addition, for profit-sharing, stock bonus and rural cooperative plans, distributions upon attainment of age 59½ or because of participant hardship are permitted. For plan years after 1988, amounts attributable to QNECs and QMACs, and any income allocated to elective deferrals after a date specified in the plan which may be no later than December 31, 1988, or, if later, the end of the last plan year ending before July 1, 1989, may not be distributed on account of hardship. Amounts may not be distributed merely because of the lapse of a period of time (such as 2 years). A plan may also provide for distributions of excess contributions or deferrals (See explanations VII.c., e., and f.)

This does not preclude distributions, even within the plan containing the CODA, of other amounts. For example: an employer maintains a profit-sharing plan containing a CODA feature that provides, in addition to contributions to the CODA, employer contributions which are neither QMACs nor QNECs. The plan may provide for distributions every 2 years (or upon any other stated event), out of these non-elective contributions. These non-elective contributions may not be taken into account for the ADP test.

401(k)(2)(B), (7)(C) and (10)
1.401(k)-1(d)

b. (i) and (ii) Profit-sharing, stock bonus and rural cooperative plans may make distributions of elective contributions on account of participant hardship. Such distributions must be in accordance with objective, nondiscriminatory standards set forth in the plan. The plan must state criteria for determining whether:

i) the participant has an immediate and heavy financial need, and

ii) the distribution is needed to satisfy the financial need.

Generally, a distribution may not be made unless the participant can meet these tests. Whether there is an immediate and heavy financial need is a question of facts and circumstances. However, a distribution made on account of (i) medical expenses described in section 213(d) of the Code; (ii) the purchase of a principal residence for the employee; (iii) the payment of college/graduate school tuition (for the next 12 months) for the employee, spouse, children or other dependents; (iv) the need to prevent eviction of the employee or foreclosure on his or her principal residence; (v) burial or funeral expenses of a parent, child, spouse or dependent; or (vi) casualty damage to the employee's principal residence is deemed to be on account of an immediate and heavy financial need.

A distribution is not necessary to satisfy the need to the extent it exceeds the amount required (including any government tax or penalty) or to the extent the need can be met from other resources reasonably available to the employee. A distribution may be treated as necessary to satisfy the need (and the plan may so provide) if the employer relies on the employee's written representation (unless the employer has actual knowledge to the contrary) that the need cannot be reasonably relieved by insurance reimbursement, reasonable liquidation of the employee's assets or the assets of the employee's spouse and minor children that are reasonably available to the employee, cessation of elective deferrals or employee contributions, borrowing from commercial sources, or other distributions or nontaxable loans from any employer. A distribution is deemed necessary to satisfy the need (and the plan may so provide) if the following requirements are satisfied:

1. the amount of the distribution does not exceed the need;
2. the employee has obtained all distributions (other than hardship distributions) and nontaxable loans available under the plans of the employer; and
3. the employee is prohibited by a legally enforceable agreement or by the terms of the plan from making elective and employee contributions to all plans of the employer (other than contributions to health or welfare benefit plans or mandatory contributions to a defined benefit plan), including non-qualified plans and cafeteria plans, for at least 6 months following the distribution.

401(k)(2)(B) and (7)(C)
1.401(k)-1(d)

c. Under section 402(g)(1), a participant generally may not defer an amount greater than the limit under section 402(g) in a taxable year, taking into account all the plans in which he or she participates. (See II.c. for the limit under section 402(g).) A plan must be written to preclude deferrals over the indexed amounts. See II.c., above. A plan may provide a mechanism by which a participant can ask that all or a portion of his or her excess deferrals (arising from participation in plans of more than one employer), and the income allocable to that amount, will be returned to him or her no later than April 15 of the year following the year in which the contributions were made. However, such a mechanism is not required as a condition of plan qualification.

Section 401(a)(30) requires as a condition of plan qualification that elective contributions under plan(s) of related employers not exceed the section 402(g) limit. A plan may provide that an employee is deemed to notify the employer of excess deferrals in this situation and the plan can distribute the excess by the first April 15 following the year in which the excess arose to avoid disqualification.

Such distributions may be made without spousal consent. If, after 2005, the plan permits Roth elective contributions, it may provide the ordering rules for distributions of excess deferrals. Alternatively, the plan may provide that the participant must choose whether the excess is distributed from his or her pre-tax or Roth elective contribution account, to the extent such type of contribution was made for the year. The amount to be distributed is the amount specified (or deemed specified) by the employee (not to exceed the elective deferrals under the plan for the year) plus allocable income or minus allocable loss. Allocable income or loss includes income or loss for the participant's taxable year and income or loss for the period between the end of the taxable year and the date of distribution (the "gap period"). For taxable years beginning before January 1, 2006, income or loss allocable to the period between the end of the taxable year and the date of distribution could be disregarded in determining income or loss on excess deferrals for such years. The plan may use any reasonable method for calculating the income or loss, provided the method is used consistently and is the normal method used by the plan for allocating income or loss to participants' accounts.

Alternatively, allocable income or loss for the taxable year is determined by multiplying the income or loss for the taxable year allocable to elective contributions by a fraction, the numerator being the excess deferrals of the employee for the taxable year and the denominator being the account balance attributable to elective contributions as of the end of the taxable year minus the income or plus the loss allocable to such account balance for the year.

The plan may determine the allocable income or loss for the "gap period" in a similar manner or, alternatively, it may determine income or loss for this period under a safe-harbor method as equal to 10 percent of the income or loss for the past taxable year times the number of months between the end of the year and the date of distribution, counting whole months only and treating distributions made after the first 15 days of the month as occurring on the first day of the next month.

A plan may provide that excess deferrals may be distributed in the year in which they were made, provided the employee and the plan designate the distribution as an excess deferral and the distribution is made after the date the excess deferral occurred.

In performing the ADP test, the plan must generally still count excess deferrals as elective contributions even if they have been distributed. However, excess deferrals made under an employer's plan (and all plans of related employers) of a non-highly compensated employee are not taken into account in the ADP test in that employer's plans. (See VII.f.(iii) regarding the coordination of distributions of excess deferrals and distributions or recharacterization of excess contributions.)

A distinction should be made between an excess deferral (i.e., an amount in excess of an individual participant's section 402(g) elective deferral limit) and an excess contribution, which is a contribution on behalf of a highly compensated employee that is above the maximum deferral percentage allowed under the ADP test for a particular plan in a particular plan year.

401(a)(30) and 402(g)
1.401(a)-30(a)
1.402(g)-1(e)

d. A plan may provide that the employer will make additional QNECs or QMACs in order to satisfy the ADP test. If this is the case, also complete Part VI. of the worksheet. (See the discussion of QNECs and QMACs in explanations V. and VI.) In this event, further correction will not be required. Note, however, that if the plan provides for QMACs which are not treated as elective contributions for the ADP test, the plan is also subject to the requirements of section 401(m). The option of making additional QNECs or QMACs to pass the test is generally unavailable to plans using the prior year testing method because additional contributions have to be made to raise the ADP of non-highly compensated employees no later than 12 months following the end of the plan year and this period has already expired when the test is run. For example, for the calendar-year 2006 testing year, the ADP test will be run in 2007, comparing the ADP of highly compensated employees for 2006 with the ADP of non-highly compensated employees for 2005. Since contributions taken into account in determining the 2005 ADP would have had to be made before 2007, if the plan fails the ADP test, it is too late to make additional contributions.

401(k)(3)(D)
1.401(k)-2(a)(6)(i) and -2(b)(1)(i)(A)

e. If the deferral percentage limits determined using the ADP test described in section 401(k)(3) are exceeded and the employer will not be making any corrective contributions, the plan is required to distribute or recharacterize the excess contributions, plus any income attributable to the excess contributions in the case of a distribution, in order for the CODA to be qualified. Excess contributions are elective contributions, and QNECs and QMACs that are taken into account for the purpose of the ADP test, contributed on behalf of the highly compensated employees, which exceed the maximum permissible deferral percentage determined using the ADP test. A plan may use a combination of additional QNECs or QMACs, distribution and recharacterization, and may also permit or require a participant to designate which of the latter two methods will be used, and to what extent each of the latter two methods will be used, provided the method is described in the plan. Similarly, if Roth elective contributions are permitted under the CODA after 2005, the plan may designate or permit the participant to designate the source of distributions. A plan may not correct excess contributions by placing them in a suspense account or by leaving them unallocated. To avoid a discriminatory rate of match, a plan generally must also forfeit matching contributions (even QMACs) that relate to contributions treated as excess deferrals (unless the excess deferrals are for non-highly compensated employees), excess contributions, or excess aggregate contributions. Such a forfeiture will not cause the plan to violate section 411.

Alternatively, the plan may contain a fail-safe formula or a procedure for prospectively reducing highly compensated employees' elective contributions so that no excess contributions arise.

401(k)(8) and 411(a)(3)(G)
1.401(k)-2(b)

f. (i) The determination of the amount of excess contributions attributable to each highly compensated employee and the identity of the highly compensated employees who will have excess contributions distributed from their accounts is performed in two separate steps. First, the total amount of excess contributions in the plan is calculated by determining the amount needed to be removed from the account of each highly compensated employee, working backward from the highly compensated employee with the greatest deferral ratio ("ADR"), so that the ratios remaining would pass the ADP test. Then, the amount so determined is distributed to highly compensated employees according to the dollar amount of their contributions used in calculating the ratio, beginning with the highly compensated employee with the greatest amount, until the total is distributed. However, if the highly compensated employee targeted for distribution has not reached his or her catch-up contribution limit for the year, the plan may not distribute the excess contributions to the extent of the unused catch-up contributions.

Example:

Employee	Compensation	Deferral	ADR	ADP
A	$100,000	$7,000	7.00%	
B	$90,000	$6,500	7.22%	6.41%
C	$80,000	$4,000	5.00%	
D	$20,000	$0	0.00%	
E	$10,000	$0	0.00%	3.33%
F	$10,000	$10,000	10.00%	

(D, E, and F are non-highly compensated employees, and the figures shown for them in this table are for the prior plan year. All employees are under age 50.)

Under the ADP test, the greatest acceptable ADP for the highly compensated employees (A, B and C) is 5.33 (see example in V.a.). Since 6.41 is greater than 5.33, there are excess contributions. Since the plan is using the prior year testing method, contributing corrective QNECs or QMACs to the non-highly compensated employees is not an option; thus, the employer must distribute or recharacterize the excess contributions.

In determining the amount of excess contributions, the proper procedure is to hypothetically reduce the highest ADR until the maximum allowed percentage (5.33) is achieved, or until the next highest ADR is reached, whichever occurs first ("ratio leveling method"). In this case, if B's ADR is reduced to 7.00, the ADP will be 6.33. Since this is not sufficient to satisfy the ADP test, A and B's ADRs must be further reduced to 5.50%. The amount of excess contributions is the difference between the contributions at the old ADRs ($7,000 and $6,500) and the contributions at the new ADRs ($5,500 and $4,950), for a total amount of $3,050. Assuming the plan corrects through distribution (and ignoring income or loss), this amount must then be distributed from the account(s) of the highly compensated employee with the highest dollar amount of contributions used in the ADP test for the plan year until the contributions remaining in such employee's account equals the plan-year contributions in the highly compensated employee's account(s) with the next highest dollar amount ("dollar leveling method"). Therefore, $500 must first be distributed to A, to make A's contributions level with B's, and the remaining amount of excess contributions, $2,550, is then allocated equally to A and B, so that each has $5,225 of elective contributions remaining for the year. (Note that the ADP test is deemed passed after these corrections even though running the test then would not produce a passing ADP for the highly compensated employees.)

401(k)(8) 414(v)(3)(B)
1.401(k)-2(b)(2)
1.414(v)-1(d)(2)(iii)

(ii) Any distribution of excess deferrals from the plan must be coordinated with the distribution or recharacterization of excess contributions as follows. (See explanation VII.c. above.) First, if excess deferrals have previously been distributed for the employee's taxable year ending with or within the plan year, then the plan must offset such distribution from the amount of the employee's excess contributions to be distributed or recharacterized for that plan year. Second, the amount of excess deferrals that may be distributed by the plan for a taxable year of the employee must be reduced by the amount of excess contributions previously distributed or recharacterized for the plan year beginning with or within that taxable year.

1.401(k)-2(b)(4)

(iii) Income or loss must be allocated to excess contributions which are to be distributed in the same manner as income or loss is allocated to excess deferrals, except that the plan year is substituted for the taxable year and excess contributions are substituted for excess deferrals in calculating the allocable income or loss. Similarly, for plan years beginning before 2006, income or loss allocable to the "gap period" (the period between the end of the plan year in which the ADP was exceeded and the date of the distribution of excess contributions) could be disregarded in determining income or loss on excess contributions for such years. (See explanation VII.c.)

401(k)(8)
1.401(k)-2(b)(2)(iv)

(iv) A distribution of excess contributions must be made after the plan year in which the excess contributions were made. However, if a distribution of an excess contribution is not made before the end of the 12 months following the end of the plan year in which they were made, the CODA will fail to be qualified for the year in which the excess contributions were made and all subsequent years until corrected. Moreover, if excess contributions are not distributed or recharacterized within 2½ months of the end of the plan year, the employer will be liable for a 10-percent excise tax on these contributions. Correction by QNECs or QMACs (only if using current year testing), even if after the 2½-month period, will enable the employer to avoid the 10-percent excise tax. The regulations provide that any distribution of excess contributions must be designated as such by the employer.

401(k)(8), 4979
1.401(k)-2(b)(5)

g. Section 401(k)(8)(A)(ii) provides that a plan may use recharacterization as a means of eliminating excess contributions. Recharacterization involves treating excess contributions as employee contributions to the plan, that is, treating the transaction as a distribution followed by a contribution to the employee's employee contribution account. Any amount so contributed must be included in the 401(m) (ACP) test. Although recharacterized excess contributions are treated as employee contributions for purposes of sections 72, 401(m)

and 401(a)(4), for other purposes, including section 404, recharacterized amounts continue to be treated as employer contributions. Recharacterized amounts are includible in the employee's gross income as if such amounts were distributed as excess contributions. Elective contributions may be recharacterized only in the plan in which they are made or under a plan with which that plan could be aggregated. Thus, elective contributions may not be recharacterized under a plan unless the plan has the same plan year as the plan under which the elective contributions were made and the same testing methods (prior year or current year) are involved. Generally, this will not be a problem as the plan to which the elective contributions were made will be the plan that recharacterizes.
401(k)(8)
1.401(k)-2(b)(3)
1.401(m)-2(c)(3)

(i) If a plan allows recharacterization it must do so in a nondiscriminatory manner. A plan which only allows employee contributions by way of recharacterization would be per se discriminatory because non-highly compensated employees would have no opportunity to contribute. Similarly, the amount recharacterized, when added to the other employee contributions for the highly compensated employees, may not exceed the limits under the plan relating to employee contributions.
1.401(k)-2(b)(3)(iii)(B)

(ii)-(v) The plan must provide that the amount of excess contributions to be recharacterized will be determined using the "leveling" methods. Thus, in the example in VII.f.(i), if the excess contributions were to be recharacterized rather than distributed, the amount of excess contributions and the identity of the highly compensated employees to whom the excess is allocated would be the same. In addition, the amount to be recharacterized is offset by any amounts previously distributed as excess deferrals. Finally, recharacterization must take place within 2½ months of the end of the plan year to which the recharacterization relates. Recharacterization will be deemed to occur on the date on which the last affected highly compensated employee is notified of the recharacterization and the tax consequences of such recharacterization. (Refer, to the explanations in VII.f. for a more detailed discussion of these requirements.)
401(k)(8)
1.401(k)-2(b)(3)(iii)(A)

VIII. Highly Compensated Employee/ Compensation

a. and b. Section 414(q) of the Code defines "highly compensated employee." This definition applies for purposes of section 401(k), including the ADP test. Effective for years beginning after December 31, 1996, the term "highly compensated employee" (HCE) means any employee who:

1) was a 5-percent owner at any time during the year or the preceding year, or

2) for the preceding year had compensation (as defined in section 415(c)(3)) from the employer in excess of $80,000 and, if the employer so elects, was in the top-paid group for the preceding year.

The $80,000 amount is adjusted at the same time and in the same manner as under section 415(d), except that the base period is the calendar quarter ending September 30, 1996. The amount is $95,000 for 2005 and $100,000 for 2006.

The only regulations under section 414(q), Temp. Regs. section 1.414(q)-1T, were written before section 414(q) was amended by the Small Business Job Protection Act of 1996, effective for years after December 31, 1996. Consequently, portions of those regulations do not reflect current law.

HCE status is determined on the basis of the applicable year of the plan or other entity for which a determination is being made ("determination year") and the preceding twelve-month period ("look-back year"). The plan must take into account employees of all employers aggregated under section 414(b), (c), (m) and (o), in determining who is a HCE. Also, for this purpose, the term "employee" includes leased employees unless such employees are covered under a safe-harbor plan of the leasing organization and not covered under a qualified plan of the employer.
401(k)(9) and 414(q)
1.414(q)-1T Q&A 6 and 7

An employer may make a top-paid group election for a determination year. The effect of this election is that an employee (who is not a 5-percent owner at any time during the determination year or the look-back year) with compensation in excess of $80,000 (as adjusted) for the look-back year is an HCE only if the employee was in the top-paid group for the look-back year.

An employer may also make a calendar year data election for a determination year. The effect of this election is that the look-back year is the calendar year beginning with or within the look-back year. This election, once made, applies for all subsequent determination years unless changed by the employer. The plan may not use this election to determine whether employees are HCEs on account of being 5-percent owners.

An employer making one of the elections is not required also to make the other election. However, if both elections are made, the look-back year in determining the top-paid group must be the calendar year beginning with or within the look-back year. These elections must apply consistently to the determination years of all plans of the employer, except that the consistency requirement will not apply to determination years beginning with or within the 1997 calendar year, and for determination years beginning on or after January 1, 1998 and before January 1, 2000, satisfaction of the consistency requirement is determined without regard to any nonretirement plans of the employer.

If a qualified plan contains the definition of highly compensated employee, and an employer makes or changes either a top-paid group election or a calendar year data election for a determination year, a plan must reflect the choices made. Any retroactive amendments must reflect the choices made in the operation of the plan for each determination year. A highly compensated former employee is based on the rules applicable to determining highly compensated employee status as in effect for that determination year. See section 1.414(q)-1T, A-4, of the temporary regulations and Notice 97-45.

c. Section 414(s) of the Code sets forth the definition of compensation that must be used for the ADP (and ACP) test.

Even if a plan incorporates the ADP test by reference, the plan must still include this definition.

The following definitions of compensation automatically satisfy section 414(s):

1. Compensation within the meaning of section 415(c)(3). For years beginning after December 31, 1997, this definition of compensation includes elective deferrals defined in section 402(g)(3), amounts deferred under a section 125 cafeteria plan or under a section 457 plan and the value of qualified transportation fringe benefits described in section 132(f). Under this definition, a self-employed person's compensation is earned income as defined in section 401(c)(2).

2. Wages as defined in section 3401(a) plus all other compensation required to be reported by the employer under sections 6041, 6051 and 6052, or wages as defined in 3401(a), both determined without regard to any rules that limit wages based on the nature or location of employment.

3. A safe-harbor definition that starts with 1 or 2, but excludes all of the following: reimbursements or other expense allowances, fringe benefits, moving expenses, deferred compensation, and welfare benefits. This safe-harbor generally permits the following definition to fall within the scope of section 414(s): Regular or base salary or wages, plus commissions, tips, overtime and other premium pay, bonuses, and any other item of compensation includible in gross income that is not listed as an exclusion in the preceding sentence. If this definition is used, any self-employed individual's compensation is to be limited to earned income multiplied by the percentage of nonhighly compensated employees' total compensation (determined on a group basis) that is included under the plan definition.

Under any of these definitions, the employer can elect to include or exclude elective contributions not includible in income, section 457(b) deferred compensation, qualified transportation fringe benefits excluded from income under section 132(f)(4) and section 414(h)(2) pick-up contributions. If any of these are included (excluded), they must all be included (excluded). Rev. Rul. 2002-27 provides that in certain situations compensation can include "deemed section 125 compensation," as defined in the ruling.

Other definitions of compensation may satisfy section 414(s) if they are reasonable, not designed to favor highly compensated employees, and if the facts and circumstances show that the average percentage of total compensation included for highly compensated employees as a group does not exceed the average percentage for nonhighly compensated employees by more than a de minimis amount. In this case, the employer must submit a demonstration that the definition is nondiscriminatory. Imputed compensation or compensation defined in reference to an employee's rate of compensation (rather than actual compensation) may not be used for purposes of the ADP (or ACP) test.

The period used to determine an employee's compensation must be the plan year, the calendar year ending in the plan year, or the portion of either during which the employee was eligible under the plan.

On May 31, 2005, proposed amendments to the section 415 regulations were published in the Federal Register. Although the regulations are not proposed to be effective until limitation years beginning after December 31, 2006, pending the issuance of final regulations, taxpayers can rely on certain portions of the proposed regulations earlier. If a plan is amended to take advantage of this earlier effective period, certain payments made within 2½ months after an employee's severance from employment may be counted in compensation and can be used as a basis for deferrals.

Compensation taken into account cannot exceed the $200,000 compensation limit described in section 401(a)(17), as adjusted by the Secretary for increases in the cost of living. Such adjustments are made in multiples of $5,000. The limit for 2006 is $220,000. See Part X below for the definition of compensation applicable to the ADP/ACP test safe harbor.

401(a)(17), 401(k)(9), 414(s), 415(c)(3)
1.401(k)-6
1.414(s)-1
1.415-2(d)
Prop. Regs. 1.401(k)-1(e)(8), 1.415(a)-1(g), 1.415(c)-2

IX. SIMPLE Provisions

Sections 401(k)(11) and 401(m)(10) of the Code (401(k) SIMPLE provisions) were added by the Small Business Job Protection Act of 1996 to provide, for years after 1996, an alternative method of satisfying the ADP and ACP tests. In addition, a plan using the 401(k) SIMPLE provisions (a SIMPLE 401(k) plan) is not treated as top-heavy under section 416 of the Code.

A SIMPLE 401(k) plan can be used only by an employer "eligible employer." An eligible employer means, with respect to any year, an employer that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year. In applying the preceding sentence, all employees of controlled groups of corporations under section 414(b), all employees of trades or businesses (whether incorporated or not) under common control under section 414(c), all employees of affiliated service groups under section 414(m), and leased employees required to be treated as the employer's employees under section 414(n), are taken into account.

An eligible employer that adopts a SIMPLE 401(k) plan and that fails to be an eligible employer for any subsequent year, is treated as an eligible employer for the 2 years following the last year the employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction, the preceding sentence applies only if the provisions of section 410(b)(6)(C)(i) are satisfied. The employer cannot have another plan covering employees who are eligible to participate in the SIMPLE 401(k). No contributions may be made during a year to a SIMPLE 401(k) plan, other than: (1) elective contributions of up to the "applicable dollar amount" (defined in section 408(p)2)(E)) plus catch-up contributions described in section 414(v), if applicable and (2) either employer matching contributions limited to 3 percent of employee's compensation or employer nonelective contributions for all eligible employees equal to 2 percent of employee's compensation. The "applicable dollar amount" is $10,000 for 2005 and 2006. The applicable dollar amount is adjusted by the Secretary of the Treasury for cost-of-living increases, in multiples of $500. The following additional requirements apply to SIMPLE 401(k) plans:

1. the plan year must be the calendar year;

2. all amounts contributed under the plan must be nonforfeitable at all times;

3. the plan must use a special definition of compensation for purposes of applying the 401(k) SIMPLE provisions; and

4. the plan must satisfy special notification and election period requirements.

Except as provided above, all other qualification requirements of the Code continue to apply to a plan that contains 401(k) SIMPLE provisions, including the contribution limitations of section 415 and the compensation limitations of section 401(a)(17). In addition, all other requirements applicable to 401(k) plans continue to apply, including the coverage and participation requirements (see explanation III.), the distribution restrictions on elective contributions (see explanation VII.a. and b.) and the general prohibition on State and local governments maintaining a 401(k) plan (see explanation I.b.).

If the plan contains 401(k) SIMPLE provisions, then this part of the worksheet must be completed.

401(k)(11), 401(m)(10), 414(v)
1.401(k)-4
1.414(v)-1

a. Coverage Limitation
No contributions can be made, or benefits accrued for services during the year, on behalf of any eligible employee under any other plan, contract, pension, or trust described in section 219(g)(5)(A) or (B), maintained by the employer.

401(k)(11)(C)

b. Calendar-Year Requirement
The plan year of a SIMPLE 401(k) plan must be the calendar year. An eligible employer adopting a SIMPLE 401(k) plan for the first time can make it effective as of any date within a calendar year that is after the date of adoption but not later than October 1st of that calendar year (or as soon as administratively feasible if the employer comes into existence after October 1). The coverage limitation of IX.a., above, still applies for the entire calendar year, and contributions and compensation are determined over the entire calendar year.

401(k)(11), 408(p)(6)(C)
1.401(k)-4(e)(3), (4) and (g)

c. Compensation
For purposes of applying the 401(k) SIMPLE provisions, compensation means the sum of the wages, tips, and other compensation from the employer subject to federal income tax withholding (as described in section 6051(a)(3)), the employee's elective contributions made under the SIMPLE 401(k) plan or any other 401(k) plan, elective deferrals under a section 408(p) SIMPLE IRA plan, a SARSEP, or, a section 403(b) annuity contract 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)). Compensation also includes amounts paid for for domestic service, as described in section 3401(a)(3). Compensation does not include any amounts deferred by the employee pursuant to a section 125 cafeteria plan. For self-employed individuals, 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. Compensation taken into account cannot exceed the $200,000 compensation limit described in section 401(a)(17), as adjusted by the Secretary for increases in the cost of living. Such adjustments are made in multiples of $5,000. The limit for 2006 is $220,000.

401(a)(17), 401(k)(11)(D), 408(p)(6)(A)
1.401(k)-4

d. Contributions

(i) Elective Contributions
Each eligible employee must be allowed to have up to the applicable dollar amount under section 408(p)(2)(E) (as adjusted by the Secretary for any increases in the cost of living) of his or her compensation contributed to the plan for a calendar year. The "applicable dollar amount" is $10,000 for 2005 and 2006. In addition, for participants aged 50 or over by the end of the year, an additional amount may be elected by the employee. The limit on these "catch-up contributions" is $2,000 for 2005 and $2,500 for 2006. After 2006, the $2,500 limit will be adjusted by the Secretary of the Treasury for cost-of-living increases, under section 414(v)(2)(C). The employer must contribute these elective contributions (also called elective deferrals) to the respective employees' accounts in the plan.

401(k)(11)(B), 414(v)
1.401(k)-4

(ii) Matching and Nonelective Contributions
Each year, the employer must contribute a matching contribution to the plan for each employee who made elective contributions. The amount of matching contributions that must be made for each employee is equal to the employee's elective contributions (including any catch-up contributions) for the calendar year; but the matching contributions cannot exceed 3 percent of the employee's compensation (as limited by section 401(a)(17)) for that entire calendar year.

For any year, instead of a matching contribution, the employer may elect to contribute a nonelective contribution equal to 2 percent of compensation (as limited by section 401(a)(17)) for the entire calendar year for each eligible employee who had compensation of at least $5,000 for the year. The plan can provide that the 2-percent nonelective contribution will be made for eligible employees making a lesser amount than $5,000, but such lesser amount must be specified in the plan and communicated to employees (see explanation IX.f.).

401(k)(11)(B)
1.401(k)-4

(iii) Limitation on Other Contributions
No employer or employee contributions may be made to a SIMPLE 401(k) plan for the year other than elective contributions described in (i), above, matching or nonelective contributions described in (ii), above, and rollover contributions described in section 1.402(c)-2, Q&A-1(a) of the regulations.

401(k)(11)(B)
1.401(k)-4

(iv) All benefits attributable to contributions made to a SIMPLE 401(k) plan must be nonforfeitable at all times.

401(k)(11)(A)(iii)

e. Employee Elections

(i) During the 60-day period immediately preceding each January 1, and during any additional periods specified by the plan, each eligible employee must be permitted to make or modify an election to defer compensation. For the year an employee becomes eligible under the SIMPLE 401(k) plan, the 60-day election period requirement is deemed satisfied if the employee may make or modify an election during a 60- day period that includes either the date the employee becomes eligible or the day before. This means that if an employee becomes eligible on July 1, for example, he or she must be given a 60-day election period that ends on June 30th, or on August 28th, or on any date in between. Employee elections must be given effect as soon as practical after the employee becomes eligible.
401(k)(11)(B)(iii)
1.401(k)-4

(ii) Each employee may terminate an election to defer compensation any time during the year.
401(k)(11)(B)(iii)
1.401(k)-4(d)(2)(iii)

f. Notice Requirements
The employer must notify each eligible employee prior to the 60-day election period described in IX.e.(i), above, that he or she can make an election to defer compensation under the SIMPLE 401(k) plan or modify a prior election during that period. The notification must indicate whether the employer will provide a 3-percent matching contribution or a 2-percent nonelective contribution.
401(k)(11)(B)(iii)
1.401(k)-4(d)(3)

X. Safe Harbor CODA Provisions

Sections 401(k)(12) and 401(m)(11) were added by the Small Business Job Protection Act of 1996 to provide, for plan years beginning after 12/31/98, a design-based or "safe harbor" method of satisfying the ADP and ACP tests. This is an alternative way of satisfying the ADP and ACP tests. If the plan, by its terms, does not satisfy the safe harbor method, it must satisfy the regular nondiscrimination test as described in this Explanation #12 (and Explanation #11 for the ACP test). A safe harbor CODA cannot "default" into ADP testing; the plan must specify whether it is or is not subject to ADP (and ACP) testing and must follow its terms. For example, plan language stating that the plan is a safe harbor plan only if the employer decides to hand out a safe harbor notice to employees, otherwise the plan will perform the ADP test, is not permitted. Rules that apply to both the ACP test safe harbor and the ADP test safe harbor are set forth in this Explanation. Explanation #11 summarizes, for the most part, rules that are only applicable to the ACP test safe harbor, or the rules that differ from those that apply to the ADP test safe harbor. Thus, Explanation #12 should always be referred to in addition to Explanation #11 with respect to the ACP test safe harbor rules.

The ADP test safe harbor requires that a plan meet certain contribution requirements (matching or nonelective) and a notice requirement. The ACP test safe harbor requires that a plan meet the contribution and notice requirements of the ADP test safe harbor and, in addition, satisfy a special limit on matching contributions. A plan providing for employee contributions, or matching contributions that fail to satisfy the ACP test safe harbor, must satisfy the regular ACP test under section 401(m)(2).

ADP test safe harbor contributions are QNECs or QMACs and are subject to the same vesting and distributions requirements. (See VI.) Thus, for example, ADP test safe harbor contributions may not be distributed on account of hardship. In addition, such contributions must satisfy the ADP test safe harbor without regard to permitted disparity under section 401(l).

A plan that uses the safe harbor method to satisfy the ADP and ACP tests for a plan year is treated as using the current year testing method for that year and is subject to the rules contained in Regs. section 1.401(k)-3.

Explanation #11 describes the ACP test safe harbor. In some cases it will be unnecessary to complete all of Explanation #11 and the accompanying worksheet if the ADP test safe harbor is met. See Explanation #11 to determine whether it must be completed. Regs. sections 1.401(k)-3 and 1.401(m)-3 describe the ADP and ACP test safe harbor in greater detail.

Generally, a plan that is intended to satisfy the 401(k) safe harbor requirements for a plan year must, prior to the beginning of the plan year, contain language to that effect and must specify the 401(k) safe harbor method that will be used. However, under Regs. section 1.401(k)-3(f), a plan that provides that it will satisfy the current year ADP (and, if applicable, ACP) testing method for a plan year may be amended to specify that the 401(k) safe harbor nonelective contribution method will be used for the plan year, provided special notices are given to employees. Also, a plan that provides for safe harbor matching contributions may suspend such contributions on future elective (or employee) contributions and change to the current year ADP (and, if applicable ACP) testing method for the plan year, provided that the additional notice requirements are met, as specified below, and in Regs. section 1.401(k)-3(g). Under section 416(g)(4)(H), for plan years beginning after 2001, a plan that consists solely of a safe harbor CODA and matching contributions that satisfy the ACP test safe harbor is not subject to the top-heavy requirements of section 416 provided contributions under the plan go to all employees eligible to make elective contributions.

a. ADP Test Safe Harbor Matching or Nonelective Contributions
There are five, alternative, methods a plan can use to satisfy the ADP test safe harbor, listed as (i) through (v) below.

(i) Safe Harbor Basic Matching Formula
The plan must provide for a plan year that a safe harbor matching contribution (a QMAC) is required to be made to the plan on behalf of each eligible employee who is a non-highly compensated employee (NHCE) equal to: (1) 100% of the amount of the employee's elective contributions that do not exceed 3% of the employee's compensation for the plan year, plus (2) 50% of the amount of the employee's elective contributions that exceed 3% of the employee's compensation but that do not exceed 5% of the employee's compensation.

(ii) Safe Harbor Enhanced Matching Formula
The plan must provide that an enhanced matching contribution is required to be made to the plan on behalf of each eligible NHCE under a formula that, at any rate of elective contributions, provides an aggregate amount of matching contributions

at least equal to the aggregate amount of matching contributions that would have been provided under the basic matching formula. In addition, under an enhanced matching formula, the rate of matching contributions may not increase as an employee's rate of elective contributions increases.

Neither (i) nor (ii) above is satisfied if, at any rate of elective contributions, the rate of matching contributions that would apply with respect to any highly compensated employee (HCE) who is an eligible employee is greater than the rate of matching contributions that would apply with respect to any NHCE who is an eligible employee and who has the same rate of elective contributions.

A plan may match elective contributions on a payroll-by-payroll basis instead of an annual basis, if the plan so provides, for purposes of satisfying the ADP test safe harbor matching contribution requirements, as long as the plan provides that matching contributions with respect to elective contributions made during a plan-year quarter are contributed to the plan no later than the last day of the immediately following plan-year quarter. The same rule applies for purposes of employee contributions that are matched. Explanation #11 describes additional rules that apply to the ACP test.

A plan meets the ADP test safe harbor with respect to matching contributions if the plan provides matching contributions on both elective contributions and employee contributions if, under the terms of the plan, either (1) the matching contributions provided on an employee's elective contributions are not affected by the amount of the employee's employee contributions or (2) matching contributions are made with respect to the sum of an employee's elective and employee contributions under the same terms as matching contributions are made with respect to elective contributions.

(iii) Safe Harbor Nonelective Contribution
The plan must provide for a plan year that a safe harbor nonelective contribution (a QNEC) is required to be made to the plan on behalf of each NHCE who is an eligible employee equal to at least 3% of the employee's compensation. (Note that safe harbor nonelective contributions (and safe harbor matching contributions) may be counted under section 416 of the Code towards the minimum contribution requirement for top-heavy plans.)

(iv) Amendment From ADP Testing to Safe Harbor Nonelective Contribution
A plan that provides that it will satisfy the current year ADP (and, if applicable, ACP) testing method for a plan year may be amended not later than 30 days before the last day of the plan year to specify that the safe harbor nonelective contribution method will be used for the plan year (including that the safe harbor nonelective contribution will be made), provided that the plan otherwise satisfies the ADP (and, if applicable, ACP) test safe harbor for the plan year (including the notice requirement modified as described under Line h (iii)).

(v) Amendment From Safe Harbor Matching Formula to ADP Testing
A plan that uses a safe harbor matching contribution method may eliminate such matching contributions on future elective and employee contributions during a plan year and instead use the current year ADP (and, if applicable, ACP) testing method for the plan year provided that the reduction or elimination of matching contributions is effective no earlier than the later of (1) 30 days after eligible employees are given the supplemental notice (described under Line h below) and (2) the date the amendment is adopted. Eligible employees must be given a reasonable opportunity (including a reasonable period) prior to the reduction or elimination of matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections. The plan must be amended to provide that the ADP test and, if applicable, the ACP test will be performed and satisfied for the entire plan year using the current year testing method, and all other safe harbor requirements must be satisfied through the effective date of the amendment. In addition, the plan must provide for and satisfy the supplemental notice requirement described under Line h (iii).

401(k)(12)
1.401(k)-3

b. The safe harbor matching contribution requirement under Line a above is not satisfied if elective contributions by NHCEs are restricted, except for the following:

(i) restrictions on the frequency and duration of election periods in which eligible employees may make or change cash or deferred elections under a plan are allowed, provided that after receipt of the required notice (see below), an employee has a reasonable opportunity (including a reasonable period) to make or change a cash or deferred election for the plan year. A 30-day period is deemed to be a reasonable period.

(ii) restrictions on the amount of elective contributions are allowed, provided that each NHCE who is an eligible employee is permitted 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. The restrictions under section 402(g) or 415 of the Code also apply and may restrict the amount of elective contributions allowed. Further, an employee's ability to make elective contributions may be suspended for 6 months due to a hardship distribution as provided in the regulations under section 401(k) of the Code.

(iii) restrictions on the types of compensation that may be deferred are allowed, provided that each NHCE who is an eligible employee is permitted to make elective contributions under a reasonable definition of compensation under section 1.414(s)-I(d)(2) of the Income Tax Regulations. Thus, the definition for purposes of restricting the types of compensation that may be deferred is not required to satisfy the nondiscrimination requirement of section 1.414(s)-I(d)(3). For example, an employer could provide that deferrals may only be made out of basic compensation, not including tips. Note that this definition is not the same as the required definition of compensation for purposes of the safe harbor matching and nonelective contribution formulas.

(iv) A plan does not fail to satisfy the ADP test safe harbor contribution requirement under section 401(k) (or the ACP test safe harbor requirements under section 401(m)) merely because employees are required under the plan terms to make cash or deferred or employee contribution elections in whole percentages of compensation or whole dollar amounts.

1.401(k)-3(c)(6)

c. Safe harbor matching and nonelective contributions must be immediately nonforfeitable regardless of the age and service of the employee or whether the employee is employed on a specific date.

401(k)(12)(E)

d. Safe harbor matching and nonelective contributions (QMACs and QNECs), and earnings thereon, must not be distributable earlier than severance from employment, death, disability, an event described in section 401(k)(10) (i.e., termination of the plan without establishment or maintenance of another defined contribution plan (other than an ESOP, a SEP, a SIMPLE IRA plan, a section 403(b) plan or a section 457 plan)), or in the case of a profit-sharing, stock bonus or rural cooperative plan, age 59½. Hardship is not a distributable event for safe harbor matching and nonelective contributions.
401(k)(12)(E)
1.401(k)-6

e. To satisfy the ADP test safe harbor and the ACP test safe harbor, the plan year must generally be 12 months long, or in the case of the first plan year of a newly established plan (other than a successor plan) the plan year is at least 3 months long (or, any shorter period in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence). Also, safe harbor CODA provisions may be added to an existing profit-sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during a plan year provided the plan is not a successor plan and the CODA is made effective no later than 3 months prior to the end of the plan year. A similar rule applies for purposes of the ACP test safe harbor in the case of the addition of matching contributions for the first time to an existing defined contribution plan at the same time as the adoption of the CODA. The plan year may also be less than 12 months if the plan has a change in plan year or terminates, but only if the special requirements in Regs. section 1.401(k)-3(e)(3) and (4) are satisfied.
1.401(k)-3(e)

f. Compensation is the definition provided for under section 1.401(k)-6 of the regulations, which incorporates by reference the definition of compensation in section 414(s) of the Code and section 1.414(s)-l of the regulations. However, the rule in section 1.414(s)-I(d)(2)(iii) which permits a definition of compensation to exclude all compensation in excess of a certain amount is not applicable. Section 401(a)(17) of the Code, imposing a dollar limit, is applicable. Solely for purposes of determining the compensation subject to a participant's deferral election, the employer may use an alternative definition (see Line b.(iii)).
1.401(k)-3(b)(2), (c)(6) and -6

g. An eligible employee is an employee eligible to make elective deferrals under the plan for any part of the plan year or who would be eligible to make elective deferrals but for a 6-month suspension due to a hardship distribution described in the plan or to statutory limitations, such as section 402(g) and 415 of the Code. Thus, there can be no last-day or 1,000-hour requirement for receiving safe harbor contributions.
401(k)(12)(B) and (C)
1.401(k)-3(b)(1) and (c)

h. Notice Requirement

(i) Content Requirement
The plan must provide that each eligible employee will be given a comprehensive notice of the employee's rights and obligations under the plan, and such notice must be written in a manner calculated to be understood by the average eligible employee. The notice must accurately describe the safe harbor matching or nonelective contribution formula used under the plan, any other contributions under the plan including the potential for discretionary matching contributions and the conditions under which the contributions are made, the plan to which safe harbor contributions will be made if different than the plan containing the CODA, the type and amount of compensation that may be deferred, how to make elections, the periods for making elections, and withdrawal and vesting provisions. A safe harbor notice may cross reference the plan's summary plan description for a portion of the information.
401(k)(12)(D)
1.401(k)-3(d)(2)

(ii) Timing Requirement
The notice must be 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 timing requirement 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. If an employee becomes eligible after the 90th day before the beginning of the plan year and does not receive the notice for that reason, the notice must be provided no more than 90 days before the employee becomes eligible and no later than the date the employee becomes eligible.
401(k)(12)(D)
1.401(k)-3(d)(3)

(iii) Additional requirements applicable to plans that change methods as described under Line a. iv and v above.
(1) If a plan changes from a current year ADP (and, if applicable ACP) testing method to use the 401(k) safe harbor nonelective contribution method, the plan will only satisfy applicable requirements if the notice given to employees before the beginning of the plan year provides that the plan may be amended during the plan year to provide that the employer will make a safe harbor nonelective contribution of at least 3 percent to the plan for the plan year, and if the plan is so amended, a supplemental notice will be given and is given to all eligible employees no later than 30 days prior to the last day of the plan year, stating that the nonelctive contribution will be made for the plan year (and the amount thereof).
(2) If a plan that uses the 401(k) safe harbor matching contribution method amends the plan to reduce or suspend matching contributions on future elective (and employee contributions, if applicable) and instead use the current year ADP (and, if applicable, ACP) testing method for the plan year, the plan must give a supplemental notice to all eligible employees, at least 30 days prior to the effective date of the amendment, explaining the consequences of the amendment and informing them of the effective date of the reduction or elimination of matching contributions and that they have a reasonable opportunity (including a reasonable period) to change their cash or deferred elections and, if applicable, their employee contribution elections. The plan must satisfy all the safe harbor requirements through the date of the reduction or suspension.
1.401(k)-3(f) and (g)

i. Another Plan

(i) Safe harbor matching or nonelective contributions may be made to the plan that contains the CODA or to another defined contribution plan satisfying section 401(a) or 403(a). The requirements applicable to the safe harbor contributions

also apply to the other plan and each employee eligible under the plan containing the CODA must be eligible under the same conditions under the other plan.
401(k)(12)(F)
1.401(k)-3(h)(4)

(ii) The plan must have the same plan year as the plan containing the CODA.
1.401(k)-3(h)(4)

(iii) Aggregation under section 410(b) is not required for safe harbor contributions to be made to another defined contribution plan, but the contributions may be used to satisfy the requirements of the safe harbor with respect to only one plan.
1.401(k)-3(h)(4)

j. Other requirements of section 401(k) apply to a CODA that is treated as satisfying the ADP test safe harbor. Thus, benefits (other than matching contributions) must not be contingent on an election to defer, and elective contributions must satisfy allocation and timing rules applicable to section 401(k) plans. A plan that satisfies the ADP and ACP test safe harbor must satisfy all other qualification requirements of the Code that are applicable to the plan, such as the nondiscriminatory availability of benefits, rights, and features under section 401(a)(4), and the limitations of sections 401(a)(17), 401(a)(30), and 415.

Section 410(b) also applies to a CODA that is treated as satisfying the ADP test safe harbor. If, pursuant to section 410(b)(4)(B), the plan provides that section 410(b) applies separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permitted under section 410(a), the plan is treated as two separate plans for purposes of section 401(k), and the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor. However, a plan that covers employees younger than age 21 or who have less than 1 year of service may not exclude such employees from receiving safe harbor contributions. For other requirements relating to CODAs, the entire Explanation #12 should be reviewed, and if section 401(m) applies, Explanation #11.
1.401(k)-3(h)