

**A Primer on the New Proposed 401(k) Regulations  
and  
Final Catch-Up Contribution Regulations**

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## **I. INTRODUCTION**

On July 17, 2003, the IRS and the Treasury Department published proposed regulations that would comprehensively update the regulations governing 401(k) plans to reflect legislative changes and incorporate, with some changes and clarifications, guidance issued by the IRS since the regulations were last revised in 1994. REG-108639-99, 68 Fed. Reg. 42475 (July 17, 2003).

The new proposed 401(k) regulations would be effective no sooner than the first plan year beginning 12 months after the publication of the final regulations in the Federal Register. Prop. Treas. Reg. §§ 1.401(k)-1(f), 1.401(m)-1(d).

The Economic Growth Tax Relief and Reconciliation Act of 2001 (“EGTRRA”) added rules permitting participants who have reached age 50 to make additional “catch-up” contributions without causing the plan to violate any nondiscrimination or other requirements, effective taxable years beginning after December 31, 2001. On July 8, 2003, the IRS and the Treasury Department published Treas. Reg. § 1.414(v)-1 in final form, which interprets this statutory change.

Among the legislative and administrative changes reflected in the proposed regulations are the following:

- The addition by the Small Business Job Protection Act of 1996 (“SBJPA”) of a rule that the ADP and ACP nondiscrimination tests which apply to elective, matching and after-tax employee contributions will be applied on the basis of prior year data unless the plan provides otherwise; effective for plan years beginning after December 31, 1996;
- The elimination by the SBJPA of the rule prohibiting tax-exempt employers from maintaining 401(k) plans, effective for plan years beginning after December 31, 1996;
- The change by the SBJPA in the method of determining which highly compensated employees (“HCEs”) will receive corrective distributions of excess elective, matching and after-tax employee contributions from a method that begins with the HCEs who have the highest contribution rates to a method that begins with the HCEs who have the largest contributions, effective for plan years beginning after December 31, 1996;
- The addition by the SBJPA of design-based safe harbor rules for satisfying the ADP and ACP tests, effective for plan years beginning after December 31, 1998;
- The addition by the SBJPA of a rule allowing a plan to disregard nonhighly compensated employees (“NHCEs”) who have not reached age 21 or have less than a one year of service in determining whether it meets the ADP and ACP nondiscrimination tests, effective for plan years beginning after December 31, 1998;

- The addition by the Tax Reform Act of 1997 (“TRA ‘97”) of a rule treating the ADP and ACP tests as satisfied by governmental 401(k) plans, effective for taxable years beginning on or after August 5, 1997;
- The announcement in Rev. Rul. 98-30 that “negative elections” will be permitted;
- The substitution by the EGTRRA of “severance from employment” for “separation from service” as a distribution event and the consequent elimination of the “same desk” rule for this purpose, effective for distributions after December 31, 2001;
- The elimination by EGTRRA of the multiple-use test (*i.e.*, simultaneous use of the 2-times or 2% prong of the ADP and ACP tests), effective for plan years beginning after December 31, 2001; and
- The reduction by EGTRRA from 12 to 6 months of the period during which a participant who has received a hardship distribution from a plan that uses the safe harbor hardship rules must be suspended from participation in that and other deferred compensation plans, effective for plan years beginning after December 31, 2001.

## **II. ADP AND ACP TESTS**

### **A. Background**

In order for elective contributions under a qualified cash-or-deferred arrangement (“CODA”) to satisfy the general nondiscrimination requirements of § 401(a)(4), either the amount of elective contributions must satisfy a mathematical nondiscrimination test called the actual deferral percentage or “ADP” test, or the design of the plan that includes the cash-or-deferred arrangement must satisfy the ADP safe harbor rules. Code § 401(k)(3) and (k)(12). Similarly, in order for matching and employee after-tax contributions to satisfy § 401(a)(4), either the amount of those contributions must satisfy a mathematical nondiscrimination test called the actual contribution percentage or “ACP” test, or (in the case of matching contributions) the design of the plan that includes the cash-or-deferred arrangement must satisfy the ACP safe harbor rules. Code § 401(m)(2) and (m)(11).

Generally speaking, the ADP compares the average rate (calculated as a percentage of compensation) at which HCEs make elective contributions to a plan to the average rate at which NHCEs make contributions to the plan, and the ACP compares the average rate at which HCEs receive matching contributions and make after-tax employee contributions to the average rate at which NHCEs receive and make such contributions. The plan to which the tests applies is usually the same plan as the plan to which the nondiscriminatory coverage requirements of § 410(b) are applied (*i.e.*, after the application of the mandatory and permissive aggregation and disaggregation rules), with some modifications,

including a requirement that contributions with respect to an HCE under multiple plans of the same employer must be aggregated. As noted above, contribution rates for HCEs for a year are compared to contribution rates for NHCEs for the prior year, unless the plan provides that current year data will be used, instead. If a plan does not satisfy or is not expected to satisfy the ADP or ACP tests for a year, various correction methods are available, including limiting contributions by HCEs, distributing excess contributions to HCEs, and making additional contributions for NHCEs.

Among the most significant modifications and clarifications to the ADP and ACP tests that would be made by the proposed regulations are the following:

**B. Aggregation of ESOPs with non-ESOPs**

As noted above, the plan to which the ADP and ACP tests applies is usually the same plan as the plan to which the nondiscriminatory coverage requirements of § 410(b) are applied, after the application of the mandatory and permissive aggregation and disaggregation rules. Those rules require the ESOP and nonESOP portions of a single plan to be disaggregated and prohibit an ESOP from being aggregated with a separate non-ESOP. The proposed regulations would override this rule for 401(k) plan testing purposes. Prop. Treas. Reg. §§ 1.401(k)-1(b)(4)(v)(A), 1.401(m)-1(b)(4)(v).

This change is designed to make ADP and ACP testing easier for 401(k) plans that treat an employer stock fund that is part of the plan as an ESOP. *See* Treas. Reg. § 54.4975-11(a)(5) (ESOP may be part of a plan). Such funds are frequently provided as an investment option or as the mandatory form of investment for certain contributions, such as employer matching contributions. Treating them as ESOPs allows the funds to benefit from the somewhat more lenient fiduciary rules that apply to ESOPs and to take advantage of the deduction provided by § 404(k) for dividends paid on stock held by an ESOP. Requiring such funds to be separately tested makes the tests more difficult to apply and also more difficult to pass, since generally more HCEs than NHCEs are interested in investing in employer stock.

The proposed regulations would not repeal the mandatory disaggregation rule for ESOPs under § 410(b). Thus, the ESOP portion of a plan still would have to satisfy the nondiscriminatory coverage requirements of that section on its own. They also would not address the proper method for valuing shares released from a suspense account for testing purposes, although the IRS has addressed this issue in a few unpublished rulings. *See* PLR 199929045 (Apr. 27, 1999), PLR 9625045 (Mar. 26, 1996).

**C. Deferrals Taken Into Account for ADP Testing**

The existing regulations provide that an elective contribution is taken into account under the ADP test for a plan year if, among other things, it attributable to

services performed by the employee in the plan year and, but for the employee's election to defer, would have been received by the employee within 2½ months after the close of the plan year. The proposed regulations would clarify that this rule is permissive, *i.e.*, elective contributions made after the end of a plan year are not required to be taken into account under the ADP test for that plan year, and may be taken into account under the ADP test for the plan year in which they are made, unless the plan provides otherwise. Prop. Treas. Reg. § 1.401(k)-2(a)(4)(i)(B)(2).

#### **D. Restriction on Matching Contributions**

Each rate of matching contribution under a plan is treated as a separate “right or feature” of the plan, which must be made available to a nondiscriminatory group of employees. The proposed regulations would not change this rule. However, they would limit the maximum rate of matching contributions taken into account for NHCEs under the ACP test to the greater of 100% or 2 times the plan's “representative matching rate.” The plan's representative matching rate is the lowest matching rate of any NHCE who is eligible to participate in the plan and is employed on the last day of the plan year (or, if greater, the lowest matching rate among a group of NHCEs that consists of half of all eligible NHCEs for the plan year—essentially the median rate). Prop. Treas. Reg. § 1.401(m)-2(a)(5)(ii).

Thus, a plan sponsor would not be allowed to take full credit for matching contributions provided to an NHCE at a rate in excess of 100%, unless it made the same or higher matching rates available to enough other NHCEs to ensure that the plan's “representative matching rate” was at least half as high. (Note that employees who receive no matching contributions are counted as zeros rather than being disregarded in calculating the plan's “representative matching rate.”)

#### **E. Restriction on Bottom-Up Leveling**

In the event of an ADP or ACP test failure, some plans use a correction method that targets qualified nonelective employer contributions (“QNECs”) to the lowest paid NHCEs in order to minimize the aggregate amount of QNECs that the employer must contribute to the plan in order to pass the test(s). Targeted QNECs are helpful because providing a QNEC to a NHCE with low compensation has a greater impact on ADP and ACP test results than providing the same QNEC to a NHCE with higher compensation. For example, making a \$1,000 QNEC on behalf of an NHCE with \$16,000 in compensation increases that employee's contribution rate that is taken into account under the ADP test by 6.25%, whereas making a \$1,000 QNEC on behalf of an NHCE with \$50,000 in compensation increases that employee's contribution rate by only 2%. This method is perfectly legal under the existing regulations, which specifically allow QNECs to be taken into account with respect to “any or all” eligible employees. Treas. Reg. §§ 1.401(k)-1(b)(5), 1.401(m)-1(b)(5).

The proposed regulations would restrict this form of correction by disregarding for purposes of the ADP and ACP tests any QNEC that is allocated to any NHCE to the extent that the QNEC (when expressed as a percentage of the NHCE's compensation) exceeds the greater of 5% of the NHCE's compensation or 2 times the plan's "representative contribution rate." The plan's representative contribution rate is the lowest applicable contribution rate of any NHCE who is eligible to participate in the plan and is employed on the last day of the plan year (or, if greater, the lowest applicable contribution rate among a group of NHCEs that consists of half of all eligible NHCEs for the plan year—essentially the median rate). Prop. Treas. Reg. §§ 1.401(k)-2(a)(6)(iv), 1.401(m)-2(a)(6)(v). For purposes of the ADP test, the applicable contribution rate for an NHCE is the sum of the QNECs and qualified matching contributions ("QMACs") made for the NHCE for the year divided by the NHCE's compensation for the year. Thus, in the previous example, in order to take full credit for the QNEC made on behalf the NHCE with \$16,000 in compensation, the plan sponsor would either have to limit the QNEC to \$800, or increase the QNECs made to enough other NHCEs to ensure that the plan's "representative contribution rate" was at least half of 6.25%.

Many plans that provide specifically for targeted QNECs have received determination letters from the IRS or are pre-approved prototype or volume submitter plans. Presumably they will have to be amended when the regulations are finalized.

#### **F. Plan Document Requirements**

The existing regulations require the plan document of a 401(k) plan to provide that the ADP and/or ACP tests will be met. They do not specifically require the plan document to state how they will be met, although some IRS offices have insisted on this level of detail when reviewing plans, on the grounds that a plan that lacks such detail does not satisfy the "definite allocation formula" requirement that applies to all profit sharing plans.

The proposed regulations would require a 401(k) plan document to specify the ADP and ACP testing methods that it uses. The tests themselves may be incorporated by reference, but any options must be specified. Prop. Treas. Reg. §§ 1.401(k)-1(e)(7), 1.401(m)-1(c)(2). The scope of this requirement is not entirely clear. The regulations would specifically require the plan to specify whether the current year testing method is to be used, and would require a plan that uses the prior year testing method to specify whether the ADP (or ACP) for eligible NHCEs for the first plan year is 3% or, instead, the ADP (or ACP) for the eligible NHCEs for the first plan year. They would not, however, specifically require a plan to specify which correction method(s) it will use.

The regulations state that, as a result of this rule, a plan that uses the safe harbor method to satisfy the ADP (or ACP) test may not provide that regular ADP (or ACP) testing will be used if the requirements for the safe harbor are not satisfied.

The IRS has taken this position administratively for several years, although the position does not seem to have been consistently applied.

#### **G. Consistency Requirements**

The proposed regulations would require a single ADP testing method and a single ACP testing method to be used for all elective, matching and after-tax employee contributions within a single plan. Prop. Treas. Reg. § 1.401(k)-1(b)(4)(ii). For example, one CODA within a plan could not use the current year testing method if other CODA(s) in the same plan used the prior year testing method.

Additionally, an employer would not be able to aggregate CODAs in separate plans that have different testing methods. Prop. Treas. Reg. § 1.401(k)-1(b)(4)(iii)(B). Similar rules would apply for employee after-tax contributions and matching contributions. Prop. Treas. Reg. § 1.401(m)-1(b)(4)(iii)(B). A plan could apply the current year testing method for ADP test purposes and the prior year testing method for ACP purposes, or vice versa, although it would limit the use of some correction methods.

#### **H. Restriction on use of Elective Deferrals for ACP Testing**

The proposed regulations would clarify that elective contributions under a plan that is not subject to the ADP test (e.g., a safe harbor plan or a § 403(b) annuity plan) may not be treated as matching contributions as a way of satisfying the ACP test. Prop. Treas. Reg. § 1.401(m)-2(a)(6)(ii).

#### **I. Prior Year Testing**

Under existing guidance, a plan that uses the prior year testing method and experiences a “coverage change” affecting more than 10% of NHCEs must use a modified ADP test. Notice 98-1, 1998-3 I.R.B. 42. Building on an example in Notice 98-1, the proposed regulations would treat a reclassification of a substantial group of employees that has the same effect as amending the plan as a “coverage change” for this purpose. Prop. Treas. Reg. §§ 1.401(k)-2(c)(4)(iii)(A)(4), 1.401(m)-2(c)(4)(iii)(A)(4).

**Example.** ABC Co. maintains two calendar year 401(k) plans, Plans P and Q, which cover employees of Divisions X and Y, respectively. Plan P covers 500 NHCEs in 2003, while Plan Q covers 300 NHCEs. ABC Co. applies the ADP test to both plans using the prior year testing method. The actual deferral percentage (“ADP”) for the NHCEs covered by Plan P in 2003 is 5%. The ADP for the NHCEs covered by Plan Q in 2003 is 10%. In 2004, ABC Co. moves 100 NHCEs of Division X to Division Y, and they become eligible to participate in Plan Q.

*The reclassification of the employees of Division X as employees of Division Y is a coverage change that affects both Plan P and Plan Q. Accordingly, for purposes of applying the ADP test in 2004, the prior year ADP for NHCEs under Plan P is the weighted average of the ADPs for its “prior year subgroups”, as defined in the regulations, and the prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for its “prior year subgroups.” Plan P has only one prior year subgroup, because the only NHCEs who would have been covered by Plan P in 2003 if the reclassification had occurred as of the first day of that year were covered by Plan P. Thus, for purposes of the 2004 testing of Plan P, the ADP for NHCEs for 2003 is 5%, the same as if the reclassification had not occurred. However, Plan Q has two prior year subgroups—the employees of Division Y who were covered by Plan Q in 2003 and the employees of Division X who would have been covered by Plan Q in 2003 if the reclassification had occurred at the beginning of that year. Thus, for purposes of the 2004 testing of Plan Q, the ADP for NHCEs for 2003 is 8.75%, calculated as follows:  $5\% \text{ (the ADP of the Plan P prior year subgroup for 2003)} \times (100/400) \text{ (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in both subgroups)} + 10\% \text{ (the ADP of the Plan Q prior year subgroup for 2003)} \times (300/400) \text{ (the number of NHCEs in the Plan Q prior year subgroup divided by the total number of NHCEs in both subgroups)}.$*

Additionally, the proposed regulations would continue the rule announced in Notice 98-1 that QNECs and QMACs must be contributed to a plan that uses the prior year testing method no later than the close of the plan year that is being tested. Prop. Treas. Reg. §§ 1.401(k)-2(a)(6)(i), 1.401(m)-2(a)(6)(i). Since this rule limits the ability of the plan sponsor to use QNECs and QMACs as a correction technique, ADP testing failures might have to be corrected by actually limiting HCE deferrals during the year being tested or through the use of corrective distributions.

The proposed regulations would retain the rule in Notice 98-1 that QNECs that are used to satisfy the ADP or ACP tests in one year using the current year testing method may not be taken into account and used to satisfy the ADP or ACP tests in the next year if the plan switches to the prior year testing method. However, they would drop the similar prohibition in Notice 98-1 against re-using elective contributions that are used to satisfy the ACP test and matching contributions (QMACs) that are used to satisfy the ADP test. Prop. Treas. Reg. § 1.401(k)-2(a)(6)(vi), 1.401(m)-2(a)(6)(vi).

## **J. Distribution of Excess Contributions/Excess Aggregate Contributions**

The proposed regulations would require that income for the “gap period” (the period between the end of the plan year being tested and the date that excess elective contributions and excess aggregate contributions are distributed in order to correct an ADP or ACP test failure) be allocated to the distributions if the plan

will credit the participant's account with income on the contributions during that period. Prop. Treas. Reg. §§ 1.401(k)-2(b)(2)(iv)(A), 1.401(m)-2(b)(2)(iv)(A). Under the existing regulations, the allocation of "gap period" income is optional.

#### **K. Recharacterization of Excess Contributions**

A failure to satisfy the ADP test can be corrected by recharacterizing the elective contributions as after-tax employee contributions. The proposed regulations would change the tax year in which the employee must include the recharacterized contributions in income from the tax year that the contributions were made to the tax year they would have been included in income if they had been distributed as excess contributions. Prop. Treas. Reg. § 1.401(k)-2(b)(3)(ii). Thus, recharacterized excess contributions that are less than \$100 generally would be included in the employee's gross income in the year they are recharacterized rather than in the prior year.

#### **L. Special Rules for HCEs who Participate in More Than One Plan**

The proposed regulations would clarify the application of the ADP and ACP tests to HCEs who participate in more than one 401(k) plans of the same employer. In particular, they would replace the current rule that requires all contributions with respect to an HCE to be treated as being made under a single arrangement with respect to the plan years ending with or within the same calendar year with a rule requiring all contributions for the 12-month period that is the same as the plan year of the plan being tested to be aggregated. Prop. Treas. Reg. §§ 1.401(k)-2(a)(3)(ii), 1.401(m)-2(a)(3)(ii).

***Example.** In the case of a plan with a 12-month plan year, the actual deferral ratio for the plan year of that plan for an HCE who participates in more than one 401(k) plan of the same employer would be the sum of all contributions during that 12-month period that would be taken into account with respect to the HCE under all such arrangements in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period.*

The proposed regulations also would clarify that corrective distributions to an HCE under a plan may not exceed the contributions actually made to the HCE's account, even if the HCE also participates in other 401(k) plans of the same employer. Prop. Treas. Reg. §§ 1.401(k)-2(b)(2)(iii)(B), 1.401(m)-2(b)(2)(iii)(B).

### **III. SAFE HARBOR PLANS**

#### **A. Background**

As noted above, effective for plan years beginning after December 31, 1998, SBJPA amended the Code to allow a 401(k) plan to avoid ADP testing with respect to elective deferrals and to avoid ACP testing with respect to matching contributions through the adoption of a "safe harbor plan." The safe harbor

exemption from ACP testing does not extend to employee after-tax contributions, although matching contributions on after-tax employee contributions can be exempted from testing under the ACP safe harbor.

**Example.** *ABC Co. has a 401(k) plan that allows a participant to make voluntary employee after-tax contributions. Even if the 401(k) plan qualifies as a safe harbor plan, the after-tax employee contributions must be tested annually under the ACP test. If ABC's plan satisfies the ACP safe harbor for matching contributions, any employer match on the after-tax employee contributions is not subject to the ACP test.*

## **B. Overview of General Requirements**

Except as noted below, the proposed regulations generally follow guidance that the IRS has issued previously regarding the implementation and operation of safe harbor plans. See Notice 2000-3, 2000-4 I.R.B. 413; Notice 98-52, 1998-46 I.R.B. 16.

### **1. 401(k) Safe Harbor for Elective Deferrals**

There are 2 basic requirements: an employer contribution and a notice to eligible employees.

#### **a. Minimum Employer Contribution**

The safe harbor plan must provide for fully vested employer contributions that are subject to the 401(k) limitations on distribution (*i.e.*, the contributions cannot be distributed until severance from employment, death, disability or certain plan terminations, and, in the case of a profit sharing or stock bonus plan, attainment of age 59½ or in the event of employee hardship). Prop. Treas. Reg. § 1.401(k)-6 (definitions of “qualified matching contribution” and “qualified nonelective contribution”). The permissible contribution formulas are as follows:

- (1) Each NHCE who is eligible to participate in the 401(k) plan must receive an employer contribution equal to 3% of the NHCE's compensation as a QNEC. Prop. Treas. Reg. § 1.401(k)-3(b)(1).
- (2) Each NHCE who is eligible to participate in the 401(k) plan must receive a matching contribution equal to 100% of elective deferrals up to 3% of the NHCE's compensation and a matching contribution equal to 50% of elective deferrals up to the next 2% of the NHCE's compensation as a QMAC. Prop. Treas. Reg. § 1.401(k)-3(c)(2).

If an employer uses QMACs to satisfy the safe harbor, the employer generally cannot restrict the ability of participants to make elective contributions. Permissible restrictions include the following:

- (a) Restricting the frequency and duration of periods in which elections can be made or changed, as long as the employee has a reasonable opportunity (including a reasonable period of time after receipt of the annual notice that an employer is required to give to eligible employees—described below) to make or change his or her election for the plan year. Thirty days is deemed reasonable.
- (b) Restricting the amount of elective contributions, provided that each NHCE is eligible to make elective contributions in an amount that is at least sufficient to receive the maximum matching contribution under the plan, and the employee is eligible to elect any lesser amount of contributions. It is permissible to require an employee to make elective deferral elections with respect to whole percentages of compensation or in whole dollar amounts.
- (c) Restricting the type of compensation that may be deferred under the plan, provided that each employee is permitted to make elective deferrals under a definition of compensation that is “reasonable” and such definition permits each employee to make such deferrals as are necessary to receive the maximum QMAC. This permits an employer to disallow elective deferrals with respect to certain types of irregular or additional compensation, such as overtime pay, shift differential payments and bonuses. In order to comply with the QMAC contribution rules however, the employer must also demonstrate that the definition of compensation does not discriminate against NHCEs. Prop. Treas. Reg. § 1.401(k)-3(b)(2), 1.401(m)-3(c).

Prop. Treas. Reg. § 1.401(k)-3(c)(6).

**Example.** *ABC Co. adopts a safe harbor plan with an employer safe harbor contribution in the form of a QMAC. The plan does not permit any employee to make elective deferrals from overtime pay. ABC Co. only pays overtime to its nonexempt employees and all of its nonexempt employees are NHCEs. Therefore, if the exclusion of overtime pay from the definition of compensation impermissibly discriminates against NHCEs (for example, discrimination could occur if overtime pay is regularly a significant portion of total NHCE compensation), the plan cannot use the exclusion for purposes of determining its employer contribution under the safe harbor QMAC formula.*

- (d) Restrictions due to Code requirements are permissible, such as the Section 402(g) limit on elective deferrals (which is \$12,000 for 2003 and \$13,000 for 2004), § 415 limit on contributions to tax-qualified retirement plans, and a required suspension of elective deferrals following a hardship distribution.
- (3) **Alternative matching formula:** The employer can use an alternative matching formula for ADP safe harbor QMACs as long as the following are satisfied:
  - (a) The rate of the matching contribution does not increase as the employee's rate of elective contributions increases.
  - (b) At any level of elective contributions, the aggregate amount of matching contributions under the alternate formula must equal or exceed the aggregate amount of matching contributions under the statutory formula.

Prop. Treas. Reg. § 1.401(k)-3(c)(3).

**Example.** ABC Co. adopts an alternate matching formula of 50% of the first 2% of compensation deferred and 100% of the next 3% of compensation deferred. This formula does not satisfy the safe harbor because (1) the rate of matching increases as the rate of deferral increases (the rate doubles once 2% of compensation has been contributed), and (2) a participant who deferred only 2% under the statutory matching formula would receive a higher match than under ABC's alternate formula (100% versus 50%). A 200% match on the first 2% of compensation deferred would satisfy the safe harbor.

- (4) An HCE is permitted to receive the ADP safe harbor QNEC or QMAC. However, in the case of the QMAC, the rate of matching provided to any HCE with respect to the HCE's elective deferrals cannot be greater than the rate of matching that would be provided to any NHCE with the same rate of elective deferrals. Prop. Treas. Reg. § 1.401(k)-3(c)(4).

**b. Notice to eligible employees**

Each employee who is eligible to participate in the safe harbor 401(k) plan must be given notice, within a reasonable period ***before the beginning of each plan year***, of the employee's rights under the safe harbor 401(k) plan.

- (1) Timing: An employer is deemed to have provided the notice within a reasonable time period if it is given at least 30 days and no more than 90 days before the first day of the plan year. *For employees who first become eligible after the 90<sup>th</sup> day before the beginning of a plan year*, the notice is deemed to have been provided within a reasonable time period if provided no more than 90 days before the employee is eligible and no later than the date the employee becomes eligible. Prop. Treas. Reg. § 1.401(k)-3(d)(3).
- (2) The annual notice must do the following:

- (a) Describe the safe harbor QMAC or QNEC formula used by the plan.
- (b) Describe any other contributions under the plan and the conditions under which such contributions are made (*e.g.*, discretionary contributions).
- (c) The plan to which the safe harbor contributions are made (if the plan is different than the 401(k) plan).
- (d) The type and amount of compensation that may be deferred under the plan.
- (e) How to make cash or deferral elections, including any administrative requirements that apply.
- (f) The periods available under the plan for making cash or deferral elections.
- (g) Withdrawal and vesting limitations applicable to contributions under the plan.
- (h) The notice can instead provide a cross-reference to an up-to-date SPD that has been provided to the employee for the items described in (b), (c), (d) and (g), as long as the notice contains the other items and also describes how the employee can obtain a copy of the SPD (*i.e.*, contact information).

Prop. Treas. Reg. § 1.401(k)-3(d)(2).

## **2. 401(m) Safe Harbor (Safe Harbor for Matching Contributions)**

- a.** The plan must comply with either the ADP safe harbor QNEC employer contribution or the ADP safe harbor QMAC employer contribution. Prop. Treas. Reg. § 1.401(m)-3(b), (c).
- b.** If the plan uses the QMAC safe harbor, the following must also be satisfied.
  - (1) Matching contributions are not made with respect to employee after-tax contributions or elective

deferrals that in the aggregate exceed 6% of the employee's compensation.

- (2) Discretionary matching contributions cannot exceed 4% of the employee's compensation.
- (3) The rate of matching contributions does not increase as the rate of employee after-tax or elective deferrals increases (which is also a requirement of the ADP safe harbor in the case of a plan that uses an alternate QMAC formula).
- (4) At any rate of employee after-tax contributions or elective deferrals, the rate of matching contributions that would apply with respect to any HCE is not greater than the rate of matching that would apply to an NHCE who had the same rate of employee after-tax contributions or elective deferrals (which is also a requirement of the ADP safe harbor in the case of an employer that uses an alternate QMAC formula).

Prop. Treas. Reg. § 1.401(m)-3(d).

- c. The annual notice to eligible employee requirement that applies under the ADP safe harbor must also be satisfied. Prop. Treas. Reg. § 1.401(m)-3(c).

### **3. Use of Two Plans**

Safe harbor QMAC or QNEC contributions may be made to a defined contribution plan that is separate from the 401(k) plan and there is no requirement that the other plan be a plan that could be aggregated with the 401(k) plan under the discrimination rules. Prop. Treas. Reg. § 1.401(k)-3(h)(4). For example, safe harbor contributions could be made to an ESOP even if the ESOP did not have a 401(k) deferral feature.

## **C. Changes from Prior Guidance**

The following are significant clarifications and changes in the new proposed 401(k) and (m) regulations as compared to prior guidance:

### **1. Exclusion of Employees From Safe Harbor Contributions**

- a. Sections 401(k)(3)(F) and 401(m)(5)(C) permit an employer to disregard NHCEs who have not completed a year of service or attained age 21 when performing the ADP and ACP tests, provided that such employees are

excluded from the determination of whether the 401(k) plan satisfies the Section 410(b) nondiscrimination test (the plan coverage test). In prior guidance, the IRS indicated that an employer could also exclude employees who were under age 21 and had completed less than a year of service from sharing in safe harbor contributions if they were also excluded for purposes of the plan coverage test. Notice 2000-3 (Q&A-10).

**Example.** *ABC Co.'s 401(k) plan covers all of ABC's employees and does not have a minimum age or service requirement. Under prior IRS guidance, ABC's plan could rely on the safe harbor even though it only made QNECs with respect to those employees who were at least 21 and had one year of service.*

- b.** The proposed regulations would eliminate the ability illustrated in the above example to exclude employees from receiving safe harbor contributions if the employee is otherwise eligible to participate. Prop. Treas. Reg. §§ 1.401(k)-3(h)(3).

## **2. Adoption Rules**

The proposed regulations would clarify that a safe harbor plan generally must be adopted before the beginning of a plan year and maintained for a full twelve month plan year. Prop. Treas. Reg. §§ 1.401(k)-3(e), 1.401(m)-3(f). There are several exceptions to this rule, most of which are a continuation of prior IRS guidance:

**Example.** *It is June 1 and ABC Co. wants to adopt a safe harbor 401(k) plan. ABC Co. does not want to change the plan's eligibility rules, so all employees who are eligible for the current plan will be eligible for the safe harbor plan. It currently has a 401(k) plan that uses the calendar year for its plan year. ABC Co. wants to adopt the safe harbor plan with an effective date of July 1—one month away. This is not permitted. ABC Co. may amend its 401(k) plan now to incorporate the safe harbor provisions, but the safe harbor cannot be effective before the next January 1 (i.e., the beginning date of the next plan year). Alternatively, ABC Co. could change its plan year to a July 1 – June 30 year and then adopt the safe harbor provisions effective with the first day of the plan's new plan year.*

- a.** A special rule allows an employer with a plan that uses the current year method for ADP and ACP testing to amend its plan (no later than 30 days before the last day of the plan

year) to adopt a safe harbor employer contribution formula. Prop. Treas. Reg. §§ 1.401(k)-3(f), 1.401(m)-3(g). For this purpose, the matching safe harbor formula cannot be used. The employer must use the 3% QNEC safe harbor formula for all NHCEs who are eligible to participate in the 401(k) plan. The employer must also meet special notice requirements, which, among other requirements, include a notice to employees that there is a possibility of the amendment as well as a notice at the time that the amendment is adopted.

- b.** A newly established plan (other than a “successor plan”) can have an initial plan year as short as 3 months (or shorter if the employer is a new employer and adopts the plan as soon as is administratively feasible after formation). A successor plan is a plan in which 50% or more of the eligible employees for the first plan year were eligible employees under a 401(k) plan maintained by the employer in the prior plan year. Prop. Treas. Reg. §§ 1.401(k)-3(e)(2), 1.401(m)-3(f)(2). For example, a 401(k) plan that is converted into a safe harbor plan would be a successor plan if the eligibility rules remained the same.
- c.** A 401(k) deferral feature can be added to an existing tax qualified defined contribution plan as late as 3 months prior to the end of a plan year, provided that the 401(k) deferral feature is not a successor plan. Prop. Treas. Reg. §§ 1.401(k)-3(e)(2), 1.401(m)-3(f)(2).
- d.** A short plan year caused by a change in the plan’s plan year does not violate the 12 month requirement, as long as the plan satisfies the safe harbor requirements during short plan year and the immediately preceding and succeeding plan years. Prop. Treas. Reg. §§ 1.401(k)-3(e)(3), 1.401(m)-3(f)(3).
- e.** A short plan year caused by a plan termination does not violate the 12 month requirement if certain participant notice requirements (content and timing) are satisfied, or if the termination is in connection with the acquisition or sale of the plan sponsor or the plan sponsor incurs a substantial business hardship. Prop. Treas. Reg. §§ 1.401(k)-3(e)(4), 1.401(m)-3(f)(4).
- f.** A plan that provides for safe harbor QMAC contributions may be amended during a plan year to eliminate the QMAC provided that certain administrative procedures are

followed. For example, the suspension of the safe harbor QMAC cannot be effective earlier than the later of 30 days after notice is given to eligible employees and the date the amendment is adopted. Prop. Treas. Reg. §§ 1.401(k)-3(g), 1.401(m)-3(h).

### **3. Suspension of Employee After-tax Contributions**

In the case of the ADP safe harbor, Notice 2000-3 contained a rule that restricted an employer's ability to limit an employee's after-tax contributions if safe harbor QMACs were provided with respect to such contributions. The proposed regulations delete this restriction with respect to the ADP safe harbor, but it is still a requirement for the ACP safe harbor if QMACs are provided with respect to after-tax employee contributions. Prop. Treas. Reg. §§ 1.401(k)-3(c)(5), 1.401(m)-3(d)(6).

### **4. HCEs Who Participate in Multiple 401(k) Plans**

Notice 98-52 provided a special rule in the case of an employer who sponsors multiple 401(k) plans in the event that an HCE participates in more than one of the employer's 401(k) plans during a plan year. In such a case, the HCE's elective contributions and matching contributions under all of the employer's 401(k) plans (*regardless of whether all of the plans are safe harbor plans*) are required to be aggregated for purposes of determining whether the HCE has a higher matching rate than any NHCE who is eligible to participate in the safe harbor plan (which if true, would result in a violation of the ADP and ACP safe harbors). The proposed regulations would not require such aggregation for purposes of the ADP safe harbor, but would retain the rule for purposes of the ACP safe harbor. Prop. Treas. Reg. § 1.401(m)-3(d)(5). However, the proposed regulations contain an exception for the ACP safe harbor if the HCE's participation in the two plans is not simultaneous (*e.g.*, in the case of an HCE who is transferred mid-year from one plan to another).

### **5. Use of Electronic Media to Deliver Safe Harbor Notices**

Notice 2000-3 provided that the safe harbor notice could be distributed electronically to a participant if (1) the system under which the electronic notice is provided is reasonably designed to provide the notice in a manner no less understandable to the participant than a written paper document and (2) under such system, at the time the notice is provided, the participant is advised that the participant may request and receive the notice on a written paper document at no charge, and upon request, the notice is provided at no charge.

- a.** The preamble to the proposed 401(k) regulations indicates that taxpayers may continue to rely on Notice 2000-3 until

proposed regulations that specifically address electronic communications to participants is released. 68 Fed. Reg. 42484 (July 17, 2003).

- b.** Department of Labor (“DOL”) electronic notification rules may apply, which are slightly different. Labor Reg. § 2520.104b-1(c). The DOL rules apply in the case of a distribution of a Summary of Material Modification (“SMM”) or summary plan description (“SPD”) to plan participants. Under the DOL safe harbor for electronic notification, in addition to the IRS requirements, distribution by electronic means is permitted with respect to active employee participants only if (1) the plan administrator takes appropriate and necessary measures to ensure that the system results in actual receipt of the SMM or SPD, (2) the notice transmitting the SPD or SMM apprises the participant of the significance of the document, (3) the participant has the ability to effectively access the electronic document at any location where the participant is reasonably expected to perform his or her duties, and (4) such access to the electronic information system is an integral part of those duties.

#### **6. Section 414(v) Catch-up Contributions**

The proposed regulations do not address whether safe harbor contributions must be made on Section 414(v) catch-up contributions. The proposed regulations invite taxpayers to submit comments on this issue. 68 Fed. Reg. 42484 (July 17, 2003).

### **IV. GENERAL AND MISCELLANEOUS ISSUES**

#### **A. Participation in 401(k) Plans by Self-employed Participants**

- The proposed regulations would make clear that self-employed plan participants (such as sole proprietors and partners) are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity that sponsors the 401(k) plan under the same rules that are applicable to common-law employees. Prop. Treas. Reg. § 1.401(k)-1(a)(6)(i).
- The proposed regulations are also conformed to the statutory change that became effective for 1997 and allows matching contributions to be made for self-employed participants. Prop. Treas. Reg. § 1.401(k)-1(a)(b)(ii).

## **B. Prefunding of Contributions**

Prefunded 401(k) contributions and prefunded matching contributions are contributions made by an employer to a 401(k) plan in anticipation of future employee elective deferrals. In Notice 2002-48, 2002-29 I.R.B. 139, the IRS indicated that it will not challenge the deductibility of prefunded 401(k) contributions as long as actual payment of the contributions is made during the taxable year for which the deduction is claimed. The proposed regulations would revoke Notice 2002-48 and provide (1) that amounts contributed in anticipation of an employee's elective deferrals or future performance of services (and in anticipation of an employer matching contribution on such future deferrals) cannot be taken into account under the ADP or ACP tests and (2) that such contributions do not satisfy any plan requirement to provide elective or matching contributions regardless of the year in which the prefunded contributions are actually paid. The result of the proposed rule would be that prefunded contributions, if made, would be subject to discrimination testing under Section 401(a)(4) (the general discrimination rule for this qualified retirement plan) and would result in disqualification of the plan if Section 401(a)(4) is not satisfied. Prop. Treas. Reg. §§ 1.401(k)-1(a)(3)(iii)(B), -1(a)(3)(vii) (Examples 3 and 4), 1.401(m)-1(a)(2)(iii).

***Example.** Employer X has a tax year that ends June 30, 2003 and sponsors a 401(k) plan with a plan year ending December 31, 2003. In anticipation of employee elective deferrals and matching contributions due on the elective deferrals between June 30 and December 31, 2003. On or before June 30, 2003, Employer X contributes the anticipated amounts to the 401(k) plan and deducts such contributions on its tax return for its taxable year ending June 30, 2003. Under the proposed regulations, the plan could be disqualified for violating Code Section 401(a)(4).*

## **C. Distribution Events**

A 401(k) plan must restrict the distribution of elective deferrals to a participant except upon a severance from employment, death, disability or certain plan terminations, and, if the plan is a profit sharing or stock bonus plan, in the event of the employee's financial hardship or attainment of age 59½. The proposed regulations would modify or clarify prior guidance as follows:

### **1. Elimination of Retirement as a Distribution Event**

“Retirement” would be eliminated as a distribution event for 401(k) elective deferrals because it is not listed in the Code as a permissible distribution event and it is subsumed by “severance from employment.” 68 Fed. Reg. 42480; *see* Prop. Treas. Reg. § 1.401(k)-1(d)(1)(i).

## **2. Severance from Employment**

The proposed regulations would clarify consistent with Notice 2002-4 and General Counsel Memorandum 39824, that a severance from employment does not occur if the employee's new employer maintains the 401(k) plan with respect to the employee, for example by assuming sponsorship of the plan or accepting a transfer of assets and liabilities with respect to the employee. Prop. Treas. Reg. § 1.401(k)-1(d)(2).

## **3. Distribution upon Termination of a 401(k) Plan**

Currently, termination of a 401(k) plan generally does not result in a permissible distribution event for 401(k) elective deferrals if the employer maintains a defined contribution retirement plan following the termination, unless the plan is an ESOP or a Simplified Employee Pension ("SEP"). The proposed regulations would expand the types of plans that an employer may maintain after terminating a 401(k) plan to SIMPLE IRA, 403(b) and 457 plans. Prop. Treas. Reg. § 1.401(k)-1(d)(4)(i).

## **4. Plan-to-Plan Transfers**

The proposed regulations would clarify that a transferor plan fails to comply with the distribution limitation on 401(k) elective deferrals (and qualified matching contributions and QNECs taken into account under the ADP test) unless it reasonably concludes that the transferee plan provides for the restriction on distribution. The IRS intends that rules similar to those in Treas. Reg. § 1.401(a)(31)-1, A-14 would apply to determine the reasonableness of the conclusion. Prop. Treas. Reg. § 1.401(k)-1(d)(5)(iv). Treas. Reg. § 1.401(a)-31 permits a transferee plan accepting a rollover to rely on the transferor plan's representation in a letter that the transferor plan is a tax-qualified plan; therefore, the proposed 401(k) regulation would presumably allow a transferor plan to rely on a representation by the transferee plan that the transferee plan will comply with the distribution limitation on the transferred 401(k) elective deferrals (and any transferred qualified matching contributions and QNECs taken into account by the transferor plan under the ADP test).

## **5. Hardship Distribution**

### **a. Clarification of Hardship Distribution Safe Harbor**

Under the existing and proposed regulations, there are two basic requirements for a hardship distribution of 401(k) elective deferrals: The employee must have an immediate and heavy financial need and the distribution must be necessary to satisfy the need. The existing regulations provide a safe harbor for complying with these requirements, but it is unclear whether a plan must use the safe harbor for both requirements (as opposed to using the safe

harbor for only one of the requirements). The proposed regulations would clarify that there is an independent safe harbor for each requirement. 68 Fed. Reg. 42480; *see* Prop. Treas. Reg. § 1.401(k)-1(d)(3)(iii)(B), -1(d)(3)(iv)(E). Upon issuance of the final regulations, plan sponsors should consider whether they prefer to rely on both of the safe harbors, only one safe harbor or none, and amend their plan documents accordingly.

**b. Clarification of Employee Representations Regarding Hardship Distributions**

For a hardship distribution of 401(k) elective deferrals, an employer is currently permitted to rely on an employee's representation regarding the necessity of the hardship distribution to satisfy the employee's financial need, provided that the employee representation meets certain requirements. The proposed regulations would modify the requirements for the employee's representation as follows: (1) The employee would be required to represent that the need cannot reasonably be relieved by any available distribution or nontaxable plan loan (even if the distribution or loan would not be sufficient to satisfy the financial need); and (2) there would be no need for the employee to take a loan from a commercial source if a loan in an amount sufficient to satisfy the need is unavailable on reasonable commercial terms. Prop. Treas. Reg. § 1.401(k)-1(d)(3)(iv)(C)(4), -1(d)(3)(iv)(C)(5).

**D. Election Procedures for Elective Deferrals**

The proposed regulations would clarify that in order for a plan to qualify as a 401(k) plan, an employee must have an effective opportunity to make (or change) an election to receive cash (instead of plan contributions) at least once during each plan year. Satisfaction of this requirement would be determined on a facts and circumstances basis; relevant facts would include notice of the availability of the election, the period of time before the cash is currently available during which an election may be made, and any conditions on elections. Prop. Treas. Reg. § 1.401(k)-1(e)(2)(ii).

**E. Contingent Benefit Rule**

Under the statute and existing regulations, an employer may not make other benefits (other than a matching contribution) contingent on the employee's elections to defer compensation under a Section 401(k) plan. For example, subject to several exceptions, an employer may not provide for additional deferred compensation under a nonqualified deferred compensation plan on account of the employee making or not making elective contributions. The proposed regulations would clarify that an employer does not impermissibly condition other benefits on a Section 401(k) election if the employer limits elective contributions to amounts

that are available (after deduction of income and employment taxes) after the application of the employee's other withholding elections (*e.g.*, payroll deductions on account of a plan loan). Prop. Treas. Reg. § 1.401(k)-1(e)(6).

## **F. Anti-abuse Rule**

In a departure from the mechanical approach to compliance taken in previous regulations, and perhaps in recognition that legislative changes since 1994 have tended to make testing more rather than less complicated, the proposed regulations would add an anti-abuse rules under which a plan will **not** be treated as satisfying the ADP or ACP tests if there are repeated changes to the plan's testing procedures or plan provisions, and the principal purpose of the changes is to manipulate the testing rules to permit higher contributions for HCEs. Prop. Treas. Reg. §§ 1.401(k)-1(b)(3), 1.401(m)-1(b)(3). This rule is the same as the anti-abuse rule that appeared in Notice 98-1.

## **V. CATCH UP CONTRIBUTIONS UNDER THE FINAL REGULATIONS**

### **A. Overview**

#### **1. Effective Date**

Final regulations governing the treatment of catch up contributions were published on July 6, 2003 and are effective for contributions for taxable years beginning on or after January 1, 2004. Treas. Reg. § 1.414(v)-1(i)(2).

#### **2. Catch-up Contributions Defined**

Catch-up contributions are defined as elective deferrals made by a catch-up eligible participant and contributed to an applicable employer plan to the extent that they exceed any of the applicable limits but do not exceed the catch-up contribution limit. Treas. Reg. § 1.414(v)-1(a)(1).

#### **3. Applicable Employer Plans**

Applicable employer plans include 401(k), 403(b), 457(b) plans maintained by governmental entities, SIMPLE and SEP arrangements. Code § 414(v)(6)(a).

#### **4. Catch-up Contribution Limits**

The general catch-up contribution limits are as follows (limitations for SIMPLE and SEP arrangements are 50% of the general limitations):

2004	\$3,000
2005	\$4,000
2006	\$5,000 (indexed for inflation after 2006)

Code § 414(v)(2)(B).

**5. Attained Age**

Any individual who participates in an applicable employer plan that has been amended to provide for catch-up contributions will be eligible to make catch-up contributions as of January 1 each year after the calendar year in which the participant attains age 49 without regard to whether any plan year begins on January 1. Code § 414(v)(2)(B).

**6. General Effect of Classification as Catch-up Contributions**

If amounts are classified as catch-up contributions for the year, they will not be taken into account for purposes of selected Code based limitations including the limitation on elective deferrals under Code Section 402(g) (\$13,000 for 2004), the limitation on annual additions under Code Section 415(c)(1) (the greater of 100% of compensation or \$41,000 for 2004) and the ADP test used for nondiscrimination testing. Code § 414(v)(1).

**B. Determination of Catch-up Contributions and Applicable Limits**

**1. Statutory Limits (Treas. Reg. § 1.414(v)-1(b)(1)(i))**

- a. Code Section 401(a)(30)** (which incorporates the **Section 402(g)** dollar limitation of \$13,000 for 2004) and Code Sections 403(b) and 457(b)(2) (same dollar limit).
  - Employees who participate in more than one plan maintained by unrelated employers may treat deferrals in excess of the Code Section 402(g) limit (\$13,000 for 2004) as catch-up contributions without regard to whether either employer classifies them in this manner. Treas. Reg. § 1.414(v)-1(b).
- b. Code Section 415(c)(1)** (\$40,000/ 100% of compensation limitation on annual additions)
  - The Code Section 415(c)(1) limitations are imposed on applicable limitation years and excesses are determined at the end of that limitation year. Treas. Reg. § 1.414(v)-1(c)(3). The other statutory limits are measured on the basis of a taxable or calendar year and excesses are determined at the time that each deferral is made.

**Example.** *P is a catch-up eligible participant and made \$13,000 in elective deferrals to his employer's 401(k) plan in the first half of 2004. When he defers an additional \$2,000 in July of 2004, the full amount will be immediately classified as a catch-up contribution because the full amount is in excess of a statutory limit. If he would have only contributed \$11,000 in the first half of 2004, the employer would have to wait until the end of the limitation year to determine whether his total deferrals exceeded the Code Section 415(c)(1) limit.*

- c. **Code Sections 402(h) and 408** (limitations relating to SEPs and IRAs)

## 2. **Employer-Provided Limits** (Treas. Reg. § 1.414(v)-1(b)(1)(ii))

### a. **Fixed Limits**

- Employer provided limits are fixed deferral limitations included in the written plan document.

**Example.** *Plan A provides that deferrals are limited to 50% of pay on a payroll basis and that no highly compensated employee may defer more than \$8,000 per year.*

### b. **Discretionary Limits**

- If a plan permits the administrator to exercise limit setting discretion, limits set by the administrator may become “employer-provided limits.”
- The Service initially took the position that plan provisions that give the administrator discretion to set deferral limitations in its discretion were not “employer-provided limitations.” However, the preamble to the final regulations states that such limitations are employer provided limitations to the extent that they are otherwise permitted under a 401(k) plan. Accordingly, if a plan document does not have a clause expressly vesting such limit setting discretion in the administrator or plan has such a clause but the sponsor does not have a determination letter (or have the ability to rely on an opinion letter) with respect to such a plan, limitations actually imposed by the

administrator should not be treated as “employer-provided limits.”

**c. Employer-Provided Limits Must be Determined on an Annual Basis**

- Employers must wait until the end of the plan year to determine whether employer-provided limits have been exceeded without regard to whether the limitation is imposed on a payroll basis. Treas. Reg. § 1.414(v)-1(b)(2)(i)(A).

**Example.** *The plan imposes a 6% payroll based limitation on HCEs but permits catch up eligible participants to defer additional amounts to the extent that they do not exceed the catch-up contribution limit. H turned 49 in 2005 and has \$120,000 in compensation in 2006. During the first quarter of 2006, he defers \$6,800 into his employer’s 401(k) plan out of compensation of \$20,000. At the end of the first quarter, it appears as though he has made a \$5,600 catch-up contribution ( $\$6,800 - (\$20,000 \times .06)$ ), however if he ceases deferrals after the first quarter, there is no catch-up contribution for the year because his deferrals for the year were less than the employer provided limit of \$7,200 ( $\$120,000 \times .06$ ).*

- If the employer provided limit is changed during the plan year, the employer may use the actual limit applied against compensation paid during that period or may use a weighted average to compute catch-up contributions. Treas. Reg. § 1.414(v)-1(b)(2)(i)(B).

**Example.** *Assume the same facts as above except that the employer provided limit is reduced to 1%, effective April 1, 2006. The employer provided limit is  $((\$20,000 \times .06) + (\$100,000 \times .01))$  or \$2,200. Under these facts, H made \$4,600 in catch-up contributions for the year ( $\$6,800 - \$2,200$ ).*

**Example.** *Assume the same facts as above except that the employer uses a weighted average approach to compute the limit. The employer provided limit is  $(\$120,000 \times (((.06 \times 3) + (.01 \times 9)) / 12))$  or \$2,700. Under these facts, H made \$4,100 in catch-up contributions for the year ( $\$6,800 - \$2,700$ ).*

- A plan may not provide a lower limit for catch-up eligible participants. Treas. Reg. § 1.414(v)-1(e)(1)(i).

**3. ADP Limit (Treas. Reg. § 1.414(v)-1(b)(1)(iii)).**

- (1) If the plan would fail the ADP test for a plan year without corrective action, the ADP limit will be an “applicable limit.”
- (2) The ADP limit is the largest dollar amount of deferrals that the plan could retain for any HCE under Code Section 401(k)(8)(C) (rules requiring distribution of excess contributions) after subtracting catch up contributions which are in excess of a statutory or employer-provided limit.

### ADP Limitation Example

- Assume the employer has six HCEs with the following attributes for the 2006 plan year ending 12/31/2006. Three (A, B and C) are eligible to make catch-up contributions. Employees A and B make deferral elections that exceed the statutory limit by the full amount of the catch-up contribution limit and those amounts are disregarded for ADP purposes. Based on the test results, the maximum amount that any HCE is permitted to contribute to the plan for the year is \$11,928.58. Accordingly, C's excess contribution of \$3,071.42 may be classified as a catch-up contribution and retained in the plan. All other HCEs will receive refunds of the full amount of excess contribution, as adjusted for earnings.
- The amount recharacterized with respect to C is still an excess contribution and matching contributions with respect to that amount may be forfeited under the plan. A plan will not be treated as being discriminatory merely because it permits matching contributions with respect to catch-up contributions. Treas. Reg. § 1.414(v)-1(d)(4).

	Employee	Compensation	Age on 12/31/05	Elective Deferrals	Amount in Excess of Statutory Limit	Net Deferral	ADR - 2006	Adjusted ADR	Distribution Amount	Excess Contribution	ADP Catch-up	Excess
A	\$100,000	65	\$20,000	\$5,000	\$15,000	15.00%	13.63%	\$ 1,370.00	\$ 3,071.42	0	\$ 3,071.42	
B	\$200,000	57	\$20,000	\$5,000	\$15,000	7.50%	7.50%		\$ 3,071.42	0	\$ 3,071.42	
C	\$75,000	49	\$15,000	\$0	\$15,000	20.00%	13.63%	\$ 4,777.50	\$ 3,071.42	\$ 3,071.42	\$ -	
D	\$100,000	40	\$15,000	\$0	\$15,000	15.00%	13.63%	\$ 1,370.00	\$ 3,071.42	0	\$ 3,071.42	
E	\$125,000	35	\$15,000	\$0	\$15,000	12.00%	12.00%		\$ 3,071.42	0	\$ 3,071.42	
F	\$30,000	28	\$15,000	\$0	\$15,000	50.00%	13.63%	\$ 10,911.00	\$ 3,071.42	0	\$ 3,071.42	
\$630,000			\$90,000			\$ 18,428.50						
Actual ADP						19.92%	12.34%					
Maximum Permitted ADP						12.34%						
Maximum Dollar Deferral						\$ 11,928.58 (Note: this is computed using percentage leveling and is not 12.34% of \$630,000)						

## C. Universal Availability

### 1. Failing Universal Availability Means Failing Code Section 401(a)(4)

A plan that is subject to the nondiscrimination rules of Code Section 401(a)(4) (401(k) plans and certain 403(b) plans) will not satisfy those rules unless it permits all catch-up eligible participants who participate under any applicable employer plan maintained by the employer (or any member of its controlled group) an effective opportunity to make the same dollar amount of catch-up contributions. Treas. Reg. § 1.414(v)-1(e). Exceptions apply with respect to plans for certain collectively bargained employees and plans maintained by governmental entities. The regulations also provide a period of deemed compliance for employers that engage in certain corporate transactions such as mergers or acquisitions. Treas. Reg. § 1.414(v)-1(e)(2)-(4).

***Example.** Company X maintains plan K, a 401(k) plan for its employees. X's wholly owned subsidiaries (X1 and X2) maintain separate 401(k) plans for their employees. Plan K permits catch-up contributions but the other plans do not. Plan K may be disqualified for violating Code Section 401(a)(4) by failing to meet the universal availability rule.*

### 2. Employer Imposed Limits May Violate Universal Availability

The universal availability requirement will not be met if the employer imposes a limitation on elective deferrals that would prevent an eligible employee from making the full dollar amount of catch-up contributions for the year.

***Example.** Employee A, 55, participates in plan K, a 401(k) plan which permits catch-up contributions but limits elective deferrals to 25% of compensation. A has compensation of \$20,000 in 2006 and wants to defer all net pay for the year but the plan prohibits deferrals in excess of 25% of compensation (\$5,000 for the year). The plan fails the universal availability rule and may be disqualified.*

### 3. Permitted Employer Proposed Limits

- A plan will not be deemed to have violated the universal availability rule if it limits deferrals to net pay. For this purpose, any fixed deferral limitation that is greater than or equal to 75% of compensation will be treated as a net pay limitation.

**Example.** Assume the same facts as in the prior example except that the plan imposes a 75% deferral limitation. Although A may be unable to make catch-up contributions because of this limitation, it does not cause the plan to violate the requirements of Code Section 401(a)(4) because it is deemed to meet the net pay exception. Treas. Reg. § 1.414(v)-1(e)(1)(ii)(B).

- Another permitted method of addressing low deferral limitations is to permit participants to make additional deferrals in excess of the general pay percentage based on the pro-rata portion of the applicable catch-up limitation for the year. Treas. Reg. § 1.414(v)-1(e)(1)(ii)(A).

**Example.** Assume the same facts as above but that the plan retains its 25% of compensation limitation but permits catch-up eligible participants to make additional deferrals of up to \$208.33 (\$5,000 / 24) per pay period in 2006. This method will meet the universal availability requirement.

#### **D. Miscellaneous**

- All applicable employer plans maintained by persons or entities that are required to be treated as the same employer under Sections 414(b), (c), (m) or (o) of the Code are required to be aggregated for purposes of these rules. Governmental 457(b) plans are excluded from this general aggregation and treated separate group of aggregated plans. Treas. Reg. § 1.414(v)-1(f)(1).
- If an employee participates in more than one of the applicable employer plans which are aggregated pursuant to the prior paragraph, the overall limitation on catch-up contributions for the year is allocated between plans using the same ordering rules set forth above. Treas. Reg. § 1.414(v)-1(f)(2).