

# Employee Benefit Plans

Explanation  
No. **11**

## Employee and Matching Contributions

The purpose of Worksheet Number 11 (Form 8799) and this explanation is to identify major problems concerning the special nondiscrimination requirements that apply to plans providing for employee and/or matching contributions (a “401(m) plan”).

This explanation, along with Worksheet #11 and Attachment #11 with the same revision date as this explanation, reflects the rules for 401(m) 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, 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(m) of the Internal Revenue Code establishes a special nondiscrimination test with respect to the amount of employee and matching contributions under a plan. Worksheet Number 11 and this explanation are to be used in those plans which are subject to the requirements of section 401(m).

Generally a “Yes” answer to a question on the worksheet indicates a favorable conclusion, while a “No” answer signals a problem concerning plan qualification. 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.**

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## I. Applicability

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Section 401(m) of the Code contains special nondiscrimination requirements relating to the amount of employee contributions and employer matching contributions under a plan. A plan will fail to satisfy the general nondiscrimination requirements under section 401(a)(4) unless it satisfies the special nondiscrimination requirements of section 401(m).

*401(m)(1)*

*1.401(m)-1(a)*

### a. Defined Contribution Plans

(i) A plan is subject to the requirements of section 401(m) if it provides for employee or matching contributions. For purposes of section 401(m), an “employee contribution” includes any contribution that is designated or treated as an after-tax contribution (other than Roth elective contributions described in section 402A of the Code and Explanation #12) and that is allocated to an individual account to which attributable earnings and losses are allocated, including contributions to the defined contribution portion of a plan described in section 414(k). In addition, employee contributions include (i) employee contributions to a qualified cost of living arrangement under section 415(k)(2)(B), whether or not allocated to an individual account to which attributable earnings and losses are allocated; (ii) employee contributions applied to the purchase of life insurance protection or survivor benefit protection under a defined contribution plan; and (iii) employee contributions to a section 403(b) annuity contract. Employee contributions do not include repayment of loans, buy-backs of benefits, rollovers or transfers from other plans, or Roth elective contributions.

A matching contribution is any employer contribution (including discretionary contributions) made on behalf of an employee on account of an elective deferral or an employee contribution to the plan. Matching contributions thus include employer contributions conditioned on the employee’s elective or employee contribution even if the amount of the employer’s contribution is not determined with reference to the amount of the elective or employee contribution. Forfeitures allocated on the basis of elective, employee or matching contributions are also matching contributions under section 401(m). Except for certain administrative considerations, a contribution is not treated as a matching contribution if it is contributed: 1) before the employee contribution, if the match relates to employee contributions; or 2) before the deferral election is made or before the performance of services with respect to which the deferral is made, if the match relates to elective deferrals. For plan years beginning before 2002, any employer contribution which is used to satisfy the top-heavy minimum contribution requirements of section 416(c)(2) is not a matching contribution for the purposes of section 401(m), regardless of whether it is allocated on the basis of elective or employee contributions.

(ii) Section 401(k) of the Code applies a special nondiscrimination test (the actual deferral percentage, or ADP, test) to elective contributions (deferrals) under a qualified cash or deferred arrangement (CODA). Elective contributions (including Roth elective contributions) are treated as employer contributions and are not tested under section 401(m). (However, also see Part II, below, regarding the use of elective contributions to satisfy section 401(m).) A CODA that would otherwise fail the ADP test because of excess elective contributions by highly compensated employees may satisfy the test by recharacterizing the excess contributions as employee contributions.

These recharacterized amounts are subject to the nondiscrimination test of section 401(m). (Note that a plan with a CODA may not limit employee contributions to those resulting from recharacterization. See Worksheet #12.)

*401(m)(4), 416(c)(2)(A)*

*1.401(m)-1(a)(2), and (3)*

### b. Defined Benefit Plans

Employee contributions generally do not include contributions to a defined benefit plan unless these contributions are allocated to a separate account as described above, such as voluntary employee contributions. The following employee contributions are deemed contributed to a defined contribution plan and are thus subject to the requirements of section 401(m):

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

2. Employee contributions to a qualified cost of living arrangement described in section 415(k)(2)(B).

*401(m)(4)*

*1.401(m)-1(a)(3)*

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## II. Discrimination

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a. A plan which provides for employee or matching contributions must satisfy the actual contribution percentage (ACP) test set forth in section 401(m)(2)(A) of the Code. For calendar years beginning after December 31, 1996, a plan subject to section 401(m) is deemed to satisfy the ACP 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 and can only be in plans containing a CODA. See Worksheet #12. Safe Harbor CODA provisions are described in section 401(k)(12) and 401(m)(11). See Part VII of this Explanation, and Part X of Explanation #12. For plan years beginning after December 31, 1996, the ACP test compares the average of the actual amounts contributed for the plan year, as a percentage of compensation, on behalf of the eligible highly compensated employees to the average of the actual amounts contributed, again as a percentage of compensation, on behalf of the eligible non-highly compensated employees for the prior year. The plan year being tested is sometimes referred to as the “testing year,” and this method of performing the ACP test, the “prior year testing method.” (See explanation V.c. for the definition of compensation.) The ACP test is computed by first separately calculating the actual contribution ratios (“ACRs”) 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 contributed on behalf of the eligible highly compensated employees may not exceed the greater of:

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

b) two plus the average of the ratios for the eligible non-highly compensated employees for the prior plan year.

Example: Ee	Comp.	Ee Contrib.	Match. Contrib.	ACR	ACP
A	\$100,000	\$3,650	\$1,825	5.48%	
B	\$90,000	\$2,100	\$1,050	3.50%	4.37%
C	\$80,000	\$2,200	\$1,100	4.13%	
D	\$20,000	\$1,000	\$500	7.50%	
E	\$10,000	\$0	\$0	0.00%	2.50%
F	\$10,000	\$0	\$0	0.00%	

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

Under the ACP test, the employer must compare the ACP of the eligible highly compensated employees (A, B, and C) to the ACP 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)  $2.50 \times 1.25 = 3.13$ . Since 4.37 is greater than 3.13, Test 1) is not met.

2)  $2.50 \times 2 = 5.00$ ,  $2.50 + 2 = 4.50$ ; 4.50 is the lesser of the two. Since 4.37 is less than 4.50, Test 2) is met and the plan passes the ACP test.

For the first plan year a plan is subject to section 401(m), the employer can elect, by so providing in the plan, to use either 3 percent as the ACP of the non-highly compensated employees or the ACP 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(m) plan of the employer in the prior year.

If elected by the employer, by so providing in the plan, the ACP test can be applied by comparing the current plan year's ACP for highly compensated employees with the current, rather than the prior, plan year's ACP for non-highly compensated employees. This method of ACP 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 Regs. section 1.401(m)-2(c)(1)(ii). 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 ACP test (unless it contains SIMPLE provisions or meets the ACP test safe harbor provisions). However, in lieu of stating the ACP test, the plan may incorporate by reference the provisions of section 401(m)(2) and the regulations thereunder. The following discussion summarizes the principal requirements of these regulations. A plan that sets forth the ACP 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 ACP is to be used for the non-highly compensated employees for the first testing year.

For plan years beginning before 2002, plans also had to 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). However, the multiple use limitation did not apply if a plan contained SIMPLE provisions or satisfied the ADP test safe harbor.

*401(m)(2)(A), 401(m)(9), (10) and (11)  
1.401(m)-1(b), (c) and -2(b)*

**b. (i) Eligible Employees**

The actual contribution ratios of all eligible employees must be taken into account in determining whether a plan satisfies the ACP test. An eligible employee is any employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions. If employee contributions are required as a condition of participation, an employee who would be a participant but for the failure to make the required contribution is considered an eligible employee for the ACP test. Also considered as an eligible employee is an employee whose right to make employee contributions or receive matching contributions has been suspended under the terms of the plan because of a distribution, loan, or an election not to participate in the plan, and an employee who may receive no annual additions because of the limits of section 415. However, an employee who makes a one-time election, upon first becoming eligible under any 401(m) plan of the employer, to not make employee contributions or receive matching contributions for the duration of his or her employment with the employer will not be considered an eligible employee for purposes of section 401(m). Eligible employees who make no employee contributions and who receive no matching contributions have an actual contribution ratio of 0% and these employees may not be excluded from the ACP test even though they may not be participants in the plan.

For plan years beginning after 12/31/98, if an employer elects to apply section 410(b)(4)(B) (relating to the exclusion of employees not meeting the statutory minimum age and service requirements), in determining whether the plan meets section 410(b)(1), the plan may provide that, in determining whether the plan meets the ACP 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(m)(5)  
1.401(m)-2(a)(1)(iii) and -5*

**(ii) Contributions Taken Into Account**

In running the ACP test for a plan year, an employee contribution will be taken into account if it is paid to the trust during the plan year. If an employee pays the contribution to an agent of

the plan (such as the employer's payroll officer), the contribution will be considered paid to the trust at the time it is paid to the agent provided it is transmitted to the trust within a reasonable period. For example, an employee contribution that is withheld from an employee's December 31 paycheck will be considered contributed to the plan in December even though the payroll officer does not transmit it to the plan until January. 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 excess contribution to a CODA that is recharacterized as an employee contribution will be taken into account for the ACP test in the plan year in which the contribution would have been received in cash if there had not been an election to defer.

A matching contribution will be taken into account for the ACP test for a given plan year only if 1) it is made on account of the employee's elective or employee contributions for that plan year, 2) it is allocated to the employee's account as of any date within that plan year, and 3) it is paid to the trust no later than the last day of the 12th month immediately following that plan year.

In addition, a non-highly compensated employee's (NHCE's) matching contribution cannot be taken into account for the ACP test to the extent it exceeds the greatest of the following:

- 1) 5 percent of the employee's compensation;
- 2) the employee's matched contributions (elective deferrals, employee contributions or both); and
- 3) the product of twice the lowest matching rate of at least half the non-highly compensated employees that made matched contributions for the year and the employee's matched contributions. An employee's matching rate is the matching contributions made for such employee divided by that employee's matched contributions, except that if the matching rate is not the same for all levels of an employee's matched contributions, the employee is deemed to have made matched contributions equal to 6 percent of compensation.

For example, assume a plan provides a match of \$2 for every \$1 of an employee's elective contributions that do not exceed 4 percent of compensation, and the plan's NHCE data for a year is as follows:

Eee	Compensation	Deferral	Match	5% of comp
A	\$10,000	\$0	\$0	\$500
B	\$10,000	\$1,000	\$800	\$500
C	\$20,000	\$1,000	\$1,600	\$1,000
D	\$30,000	\$0	\$0	\$1,500
E	\$60,000	\$1,000	\$2,000	\$3,000

B and E's matches can be counted in the ADP test because they are either less than 5 percent of compensation or less than the employee's deferral. C's match exceeds 5 percent of compensation and the amount of deferral, so it can only be counted if it does not exceed the product of 1) twice the lowest matching rate given to at least two of employees B, C and E and 2) C's \$1,000 of deferrals. Since the matching rate changes (the rate is lower for deferrals above 4 percent of compensation), employees B, C and E are deemed to have

made deferrals of 6 percent, producing matching rates of 1.33 (800/600), 1.33 (1,600/1,200) and 0.56 (2,000/3,600), respectively. Since B and C have a matching rate of 1.33, \$1,330 (1.33 x \$1,000) of C's matching contribution can be counted because it does not exceed the product of twice the matching rate of at least half the non-highly compensated employees (B and C) who made deferrals and C's deferrals.

A matching contribution which does not meet all of these requirements will not be tested under section 401(m). Instead, the contribution must independently satisfy section 401(a)(4) for the plan year of allocation as if it were the only employer allocation for that plan year. (See also 1.(a). (ii).)

Matching contributions that are forfeited to meet the ACP test or because they relate to excess deferrals or excess contributions (see Worksheet #12) or to excess aggregate contributions (see IV.b., below) are not counted in the ACP test.

Under certain circumstances, an employer may treat elective contributions to a cash or deferred arrangement (i.e., elective deferrals) and certain non-elective contributions (i.e., qualified non-elective contributions, or QNECs) as matching contributions for purposes of the ACP test. If the terms of the plan provide for this, then Part III. of the worksheet should also be completed.

401(m)(3)  
1.401(m)-2(a)(4) and (5)

(iii) and (iv) Aggregation

If an employer maintains more than one plan which is subject to the ACP limits of section 401(m), 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 employee and matching contributions are treated as made under a single plan for purposes of the ACP test as well as for purposes of sections 401(a)(4) and 410(b). Two or more plans subject to section 401(m) may be permissively aggregated if the aggregated plans satisfy the ACP 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 plans are treated as a single plan for purposes of sections 401(a)(4) 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 ACP (and ADP) 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 ACP for non-highly compensated employees is the sum of the ACPs of the employer's plans these employees were in during the preceding year, with each such plan's preceding year ACP 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(m), with the average ACPs 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 ACP is 2.75.  $[(2 \times 200/400) + (3 \times 100/400) + (4 \times 100/400)] = 2.75$

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

Whenever a highly compensated employee is eligible under more than one plan of the same employer subject to section 401(m), this employee's actual contribution ratio is calculated by treating all the plans subject to section 401(m) as one plan. 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 ACP test.

*401(m)(2)(B)*  
*1.401(m)-1(b)(4), -2(a)(3)(ii) and -2(c)(4)*

(v) Use of Relevant Plan Years

The plan must use the proper plan years when determining the ACPs of the highly compensated employees and of the non-highly compensated employees. As described in II.a., above, if the plan is using the prior year testing method, the ACP of highly compensated employees for a testing year is determined using current plan year (testing year) data while the ACP 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 ACPs 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(m)(2)*

c. In addition to satisfying the ACP test, a plan that provides for employee or matching contributions must make such contributions available to employees on a nondiscriminatory basis. The determination of whether a rate of matching contributions is discriminatory is made only after the plan has made corrective distributions of amounts in excess of the ACP test (as well as the ADP test that applies to a cash or deferred arrangement). (See explanation IV.b.) However, some formulas for employee or matching contributions may be, per se, discrimi-

natory, e.g., where the availability of employee or matching contributions is limited to employees with compensation in excess of the integration level under the plan.

A plan is required to 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 employee contributions and to receive each level of matching contributions. To satisfy this availability requirement, a benefit, right or feature must be available to a group of employees that satisfies section 410(b).

*401(a)(4)*  
*1.401(a)(4)-4*  
*1.401(m)-1(a)(1)(ii)*

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### III. Elective Contributions and QNECs

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A plan which includes a qualified cash or deferred arrangement (CODA) is subject to the requirements of section 401(k) of the Code. (See Worksheet #12.) Section 401(k) includes an actual deferral percentage (ADP) test which is identical to the ACP test except that elective contributions (i.e., CODA deferrals) are substituted for employee and matching contributions. Under certain circumstances an employer may elect to treat certain matching contributions as elective contributions in performing the ADP test. Matching contributions that are eligible to be treated as elective contributions are referred to as qualified matching contributions (QMACs). A QMAC is a matching contribution that is both fully vested when it is made to the plan and subject to certain 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. QMACs that an employer takes into account for the ADP test are disregarded in performing the ACP test. Thus it is possible that a plan which provides for matching contributions may not have to satisfy the ACP test, e.g., where the only matching contributions are QMACs that the employer makes solely to satisfy the ADP test. An employer may also, under certain circumstances, take into account for the ADP test qualified non-elective contributions (QNECs). QNECs are any 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. A plan must provide a definite allocation formula for QNECs. On the 401(m) side, the employer may, under certain circumstances described in section 1.401(m)-2(a)(6) of the regulations, treat as matching contributions for the ACP test elective contributions under a CODA and QNECs.

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 ACP (or ADP) 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 elective contributions will be taken into account for the ACP test or if the plan provides that the employer will make additional QNECs if necessary to satisfy the ACP 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)** A QNEC must be fully vested 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 ACP test. For example, if an employer makes a contribution of \$100 which is 50% vested in year one and 100% vested in year two, then no part of the contribution will be treated as a QNEC in either year. Also, forfeitures cannot be used as QNECs because such contributions are not fully vested when made to the plan.

*401(m)(4)(C)*

*1.401(m)-5*

**(ii)** QNECs may be distributed only under the following circumstances:

a. death, disability, or severance from employment;

b. 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) and the distribution is in the form of a lump sum;

c. in the case of a profit-sharing, stock bonus or rural cooperative plan, attainment of age 59½

However, amounts attributable to QNECs may not be distributed on account of hardship for plan years beginning after 1988, 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, the QNECs must be subject to these distribution limitations regardless of whether they are actually taken into account for the ACP test.

*401(k)(7)(C), 401(m)(4)(C)*

*1.401(m)-5*

**b.** If the plan provides that it will take QNECs and elective contributions into account for purposes of the ACP test, it must limit the QNECs and elective contributions that will be treated as matching contributions to those contributions that are made with respect to employees who are eligible employees under the section 401(m) plan being tested. QNECs cannot be used in an ACP test if they have already been used in an ADP test or another ACP test (e.g., in an ACP 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 matching contributions only if the additional requirements described below and specified in section 1.401(m)-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 matching contributions for the ACP test and QNECs treated as elective contributions for the ADP test, satisfy section 401(a)(4).

2. The non-elective contributions, excluding QNECs treated as matching contributions for the ACP test and QNECs treated as elective contributions for the ADP 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 ACP test in different years.)

3. The CODA under which the elective contributions are made, including those treated as matching contributions, is required to satisfy the ADP test. Thus, elective deferrals made to a section 403(b) plan or elective contributions under a safe harbor CODA cannot be used in the ACP test since they were not subject to the ADP test.

4. The QNECs are allocated to the employee as of a date within the relevant plan year, and the elective contributions relate to compensation that would have been received in the plan year, or compensation for services performed in the plan year that would have been received within 2½ months after the plan year, and are allocated as of a date within the plan year. (See Worksheet #12 and the accompanying explanation regarding when an elective contribution (or QNEC) is considered allocated within a plan year.)

The plan which treats QNECs and elective contributions as matching contributions and the plan to which the QNECs and elective contributions are made must have the same plan year and otherwise could be aggregated for purposes of ACP testing. Thus, elective contributions made under a CODA that uses prior year testing could not be used in an ACP test using current 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 ACP test if it is greater than twice the lowest QNEC and matching percentage given to at least half the eligible non-highly compensated employees. An employee's QNEC and matching percentage is the amount of QNECs and matching contributions made for the employee for the plan year divided by the employee's compensation.

Example:

An employer has four non-highly compensated employees eligible for its 401(m) plan and they have compensation for the plan year of \$1,000, \$10,000, \$20,000 and \$50,000. None of the four receive any matching contributions. 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 ACP of the non-highly compensated employees.

*401(m)(3)*

*1.401(m)-2(a)(6), (c)(3)*

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## IV. Corrections

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A plan which would otherwise fail the ACP test can avoid such failure, and the consequent loss of qualified status, in either of two ways. The first method involves making additional

employer contributions (QNECs or matching contributions), in accordance with the terms of the plan, so that the ACP test is passed. This option is generally unavailable to plans using the prior year testing method because additional contributions have to be made to raise the ACP of non-highly compensated employees no later than the last day of the 12th month immediately following the plan year and this period has already expired when the test is run. For example, for the calendar-year 2006 testing year, the ACP test will be run in 2007 comparing the ACP of highly compensated employees for 2006 with the ACP 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 ACP test, it is too late to make additional contributions.

The second method involves distributing or forfeiting the amounts in excess of the ACP limits. These two methods are the exclusive means by which a plan may correct an otherwise failed ACP test. Thus, a plan may not satisfy the ACP test by failing to make matching contributions that are required under the terms of the plan or by allocating amounts in excess of the ACP limits to a suspense account and then allocating these amounts back to participants' accounts in subsequent years.

The plan need not contain a method for correction if it contains provisions that will ensure the ACP test is always satisfied.

*401(m)(3) and (6)*  
*1.401(m)-2(a)(6)(i) and -2(b)*

**a.** If the plan is using the current year testing method, it may provide that, in order to satisfy the ACP test, the employer will make additional matching contributions or QNECs. If this is the case, also complete Part III. of the worksheet. (See the discussion of QNECs in explanations II. and III.) In this event, further correction will not be required.

*401(m)(3)*  
*1.401(m)-2(b)*

**b.** A plan may provide that if the ACP limit is exceeded the plan will distribute (or forfeit, if forfeitable) the excess aggregate contributions plus the income that is allocable to these contributions. To avoid a discriminatory rate of match, a plan generally must 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. (See Worksheet #12 for the definition of "excess deferrals" and "excess contributions.") Such a forfeiture will not cause the plan to violate section 411. Excess aggregate contributions means the excess of the total of matching and employee contributions (plus QNECs and elective contributions treated as matching contributions) made on behalf of each highly compensated employee over the employee's maximum permissible contribution ratio determined in accordance with IV.c.(i) below. A distribution of excess aggregate contributions may be made without spousal consent.

*401(m)(6), 411(a)(3)(G)*  
*1.401(m)-2(b)(2), (3)(i) and (3)(v)(B)*

**c.** (i) The determination of the amount of excess aggregate contributions attributable to each highly compensated employee and the identity of the highly compensated employees who will have excess aggregate contributions distributed (or forfeited, if forfeitable) from their accounts is performed in two separate steps. First the total amount of

excess aggregate contributions in the plan is calculated by determining the amount needed to be removed from the accounts of each highly compensated employee, working backward from the highly compensated employee with the greatest contribution ratio ("ACR"), so that the ratios remaining would pass the ACP test. Then, the amount so determined is distributed (or forfeited, if forfeitable) 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.

Example:

Eee	Comp.	Eee Contrib.	Match	ACR	ACP
A	\$100,000	\$4,000	\$2,000	6.00%	
B	\$90,000	\$3,900	\$1,950	6.50%	5.54%
C	\$80,000	\$2,200	\$1,100	4.13%	
D	\$20,000	\$1,000	\$500	7.50%	
E	\$10,000	\$0	\$0	0.00%	2.50%
F	\$10,000	\$0	\$0	0.00%	

(A, B and C are highly compensated employees. D, E, and F are non-highly compensated employees, and the figures shown for them in this table are for the prior plan year.) Under the ACP test, the greatest acceptable ACP is 4.50 (see example in II.a.). Since 5.54 is greater than 4.50, there are excess aggregate contributions. Since the plan is using the prior year testing method, contributing corrective QNECs or matching contributions to the non-highly compensated employees is not an option; thus, the plan must distribute (or, if forfeitable, forfeit) the excess aggregate contributions.

In determining the amount of excess aggregate contributions, the proper procedure is to hypothetically reduce the highest ACR until the maximum allowed percentage (4.50) is achieved, or until the next highest ACR is reached, whichever occurs first ("ratio leveling method"). In this case, if B's ACR is reduced to 6.00, the ACP will be 5.38. Since this is not sufficient to satisfy the ACP test, A and B's ACRs must be further reduced to 4.69%. ( $4.69 + 4.69 + 4.13 = 13.51$ ;  $13.51 \div 3 = 4.50$ ). The excess aggregate contributions is the difference between the contributions at the old ACPs (\$6,000 and \$5,850) and the contributions at the new ACPs (\$4,690 and \$4,221), for a total amount of \$2,939. This amount must then be distributed (or forfeited, if forfeitable) from the account(s) of the highly compensated employee with the highest dollar amount of contributions used in the ACP 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, \$150 must first be distributed to (or forfeited from, if forfeitable) A, to make A's contributions level with B's, and the remaining amount of excess aggregate contributions, \$2,789, is then allocated equally to A and B, so that each has \$4,455.50 of employee and matching contributions remaining for the year. (Note that the ACP test is deemed passed after these corrections even though running the test then would not produce a passing average ACP for the highly compensated employees.)

*401(m)*  
*1.401(m)-2(b)(2) and (3)*

(ii) Section 401(k) of the Code and the regulations thereunder also provide mechanisms for correcting excess contributions to a qualified cash or deferred arrangement, i.e., elective contributions (and other amounts treated as elective contributions) in excess of the actual deferral percentage (ADP) limits. One method of correcting excess contributions under a qualified cash or deferred arrangement is to recharacterize the excess contributions as employee contributions. If a plan of the employer includes a cash or deferred arrangement that provides for recharacterization, the recharacterized amount is then subject to the ACP limits of section 401(m). The determination of the amounts of excess aggregate contributions resulting from application of the ACP test may be made only after determining the excess contributions to be recharacterized as employee contributions for the plan year.

Example:

Plan X uses a calendar-year plan year and has two eligible employees: A, who is highly compensated; and B, who is non-highly compensated. Plan X contains a qualified CODA and also provides that the employer will match an employee's contributions to the extent such contributions do not exceed 3% of compensation. Elective contributions that are in excess of the ADP limit are recharacterized and excess aggregate contributions are distributed or, if forfeitable, forfeited. The elective, employee and matching contributions under Plan X for its 2006 testing year are as follows:

Ee	Comp.	Elective	Eee Contrib.	Match.
A	\$100,000	\$7,000	\$5,000	\$3,000
B	\$20,000	\$800	\$600	\$600

When the employer calculates the ADP test, it determines that there is an excess contribution of \$1,000 because the maximum A is permitted to elect to defer is the percentage deferred by B (4%) plus 2%. The \$1,000 is therefore recharacterized under the plan as an employee contribution and is includible in A's 2006 income (unless attributable to Roth elective contributions described in section 402A, which have already been included in income). In performing the ACP test, this \$1,000 must be added to the \$8,000 employee and matching contributions made on behalf of A for the same plan year. A's limit under the ACP test is \$8,000 (6% + 2%). Therefore, A has an excess aggregate contribution of \$1,000, which must be distributed or forfeited.

401(m)

1.401(m)-2(a)(4)(ii)

(iii) Any distribution or forfeiture of excess aggregate contributions must include the income or loss allocable to these contributions. Allocable income or loss includes income or loss for the plan year in which the ACP was exceeded and income or loss for the period between the end of the plan year and the date of distribution (the "gap period"). For plan years beginning before 2006, income or loss allocable to the gap period could be disregarded in determining income or loss on excess aggregate contributions 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 plan year can be determined by multiplying the income or loss for the plan year allocable to employee and matching contributions by a fraction, the numerator being the excess aggregate contri-

butions allocated to the employee for the plan year and the denominator being the account balance attributable to employee and matching contributions as of the end of the plan year minus the income or plus the loss allocable to such account balance for the plan 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 plan 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.

401(m)

1.401(m)-2(b)(2)(iv)

(iv) The method of distributing excess aggregate contributions must be nondiscriminatory. If the plan distributes a highly compensated employee's matched employee contributions without forfeiting the corresponding matching employer contributions, it will fail this requirement. A plan may distribute unmatched employee contributions first, or distribute (or forfeit) employer matching contributions before distributing employee contributions. However, if the plan distributes matched employee contributions, there must be a proportional forfeiture of matching contributions.

401(a)(4), 411(a)(3)(G)

1.401(m)-2(b)(3)(v)(B)

(v) A corrective distribution of excess aggregate contributions must be made after the plan year in which the excess aggregate contributions arose and no later than the last day of the 12th month immediately following that plan year. If a plan fails to correct excess aggregate contributions before the end of this 12-month period, the plan will not be qualified for the year in which the excess aggregate contributions were made and all subsequent plan years until corrected. Further, if excess aggregate contributions are not corrected 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 matching contributions (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 aggregate contributions must be designated as such by the employer.

401(m), 4979

54.4979-1

1.401(m)-2(b)(4)

(vi) The plan must provide that a distribution or forfeiture of excess aggregate contributions will be made on the basis of the respective amounts that are attributable to each highly compensated employee. See explanation at IV.c.(i).

401(m)(6)(C)

1.401(m)-2(b)(2)(iii)

d. The plan need not contain methods for correcting a failure of the ACP test if it contains a fail-safe formula (e.g., employee contributions are limited to 2% and 2% QNECs are given to all employees) or a procedure for prospectively reducing the employee contributions of highly compensated employees so that no excess contributions arise.

1.401(m)-2(b)(1)(ii)

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## V. Highly Compensated Employee/ Compensation

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**a. and b.** Section 414(q) of the Code defines “highly compensated employee.” This definition applies for purposes of the ACP 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(m)(3)(B) 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 ACP (and ADP) test. Even if a plan incorporates the ACP 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 ACP (or ADP) 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*

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## VI. Reserved

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## VII. Safe Harbor CODA

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Section 401(m)(11) was 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 ACP test. The ACP test safe harbor requires that a plan meet the contribution and notice requirements of the ADP test safe harbor described in Explanation #12 and, in addition, satisfy a special limit on matching contributions. A plan providing for after-tax 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). Explanation #12 should always be referred to in addition to this Explanation because the rules that apply to the ADP test safe harbor and to the ACP test safe harbor are noted in Explanation #12.

**a.** (i),(ii),(iii). Section 401(m)(11) of the Code provides that a plan is deemed to meet the nondiscrimination requirements of section 401(m) with respect to matching contributions if the plan meets an ADP test safe harbor contribution formula, satisfies notice requirements under section 401(k)(12), and provides for a limitation on matching contributions. A plan may provide for a basic matching formula, an enhanced matching formula, or a nonelective contribution formula, as described in Explanation #12.

However, in order to satisfy the ACP test safe harbor with respect to matching contributions, they must satisfy the remainder of this Part VII. If after-tax employee contributions are permitted under the plan, it will have to satisfy the ACP test with respect to those contributions.

If a plan changes from a current year ADP or ACP testing method to a safe harbor nonelective contribution method for the plan year, or from a safe harbor matching contribution method to the current year ADP/ ACP testing method, additional rules apply, as discussed in Explanation #12. Explanation #12 should always be referred to in addition to this Explanation for applicable rules.

To determine whether the plan has met all applicable requirements, first see Explanation #12 and complete Worksheet #12.

*401(m)*

*1.401(m)-3*

**b.** If the plan provides for matching contributions, unless they are required to satisfy the ADP test safe harbor, they are not required to be immediately nonforfeitable.

(i) These contributions may be subject to a vesting schedule described under section 411 of the Code.

(ii) The ACP test safe harbor is met if (1) matching contributions may not be made with respect to employee contributions or elective contributions that in the aggregate exceed 6% of the employee's compensation, (2) the rate of matching contributions may not increase as the rate of employee contributions or elective contributions increases, (3) at any rate of employee contributions or elective contributions the rate of matching contributions that would apply with respect to any HCE who is an eligible employee is no greater than the rate of matching contributions that would apply with respect to an NHCE who is an eligible employee and who has the same rate of employee contributions or elective contributions and (4) restrictions on elective or employee contributions are limited to those described in Explanation #12, section X, line b.

*401(m)(11)(B)*

*1.401(m)-3(c) and (d)*

**c.** Even though matching contributions made at the employer's discretion may not be taken into account in determining if the ADP test safe harbor is satisfied, a plan that satisfies the ADP test safe harbor may provide for discretionary matching contributions in addition to any matching contributions needed to satisfy the ADP test safe harbor. However, a plan fails to satisfy the ACP test safe harbor for a plan year if the plan provides for matching contributions made at the employer's discretion on behalf of any employee that, in the aggregate, could exceed a dollar amount equal to 4% of the employee's compensation.

*1.401(m)-3(d)(3)(ii)*

**d.** Even if a plan satisfies the ACP test safe harbor with respect to matching contributions, the plan must still satisfy the regular ACP test as described in this Worksheet #11, as modified below, with respect to after-tax employee contributions. The regular ACP test must also be performed if matching contributions fail to satisfy the ACP test safe harbor. In applying the ACP test, an employer may elect to disregard all matching contributions if the ACP test safe harbor is satisfied, or just matching contributions that do not exceed 4% of each employee's compensation if the plan provides for a matching formula that satisfies the matching contribution requirement under the ADP test safe harbor. QNECS may be treated as matching

contributions to the extent permitted under section 1.401(m)-2(a)(6) if they are not needed to satisfy the ADP test safe harbor contribution requirement. In applying the ACP test, matching contributions may not be treated as elective contributions under section 401(k)(3)(D) of the Code to a CODA that satisfies the ADP test safe harbor and elective contributions under a CODA that satisfies the ADP test safe harbor may not be treated as matching contributions under section 401(m)(3).

*1.401(m)-2(a)(5)(iv) and -3(j)*

**e.** Reserved

**f.** Matching contributions are taken into account for a plan year under the ACP test safe harbor in accordance with the allocation and timing rules of section 1.401(m)-2(a) of the regulations, which provides that a matching contribution is only taken into account for a plan year if the contribution is allocated to the employee's account under the terms of the plan as of any date within the plan year, is actually paid to the trust no later than 12 months after the close of the plan year, and is made on behalf of an employee on account of the employee's elective contributions or employee contributions for the plan year. However, if it so provides, a plan may match elective and/

or employee contributions on a payroll-by-payroll basis instead of an annual basis for purposes of satisfying the ACP test safe harbor, as long as the plan provides that matching contributions for a plan-year quarter are contributed to the plan no later than the last day of the immediately following plan-year quarter.

*1.401(m)-3(d)(4) and -3(j)*

**g.** A plan will not fail to satisfy the ACP test safe harbor merely because, after a hardship withdrawal of elective contributions from the plan, the plan suspends additional employee contributions for a period of 6-12 months. See Explanation #12 for additional allowable restrictions on elective contributions, with respect to the safe harbor matching contribution requirement.

*1.401(m)-3(d)(6)(v)*

**h.** The rules that apply for purposes of aggregating and disaggregating CODAs and plans under section 401(k) and (m) also apply to safe harbor plans, except there is a special rule in section 1.401(m)-3(d)(5) of the regulations for highly compensated employees who participate in both a safe harbor plan and a non-safe harbor plan of the employer at different times during the year.

*1.401(m)-3(d)(5)*