

**CHAPTER 13-- CASH OR DEFERRED ARRANGEMENTS--  
SELECTED EXAMINATION ISSUES**

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## INTRODUCTION

### DEFINITION OF A CODA

Any plan that allows a participant to make a cash or deferred election has a CODA. Only a profit-sharing, stock bonus, pre-ERISA money purchase pension plan or a rural cooperative plan may contain a CODA.

A cash or deferred election is an election by an employee to have the employer either:

- (1) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available (only cash for a qualified CODA) or
- (2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

If there is such an election, then the plan contains a CODA, even if an employer does not intend to offer one. This could have serious consequences since the plan, if permitted, would be required to pass the nondiscrimination ADP test. If a CODA is not permitted, the plan would be disqualified.

A cash or deferred arrangement may be made effective as of the first day of the plan year, but the deferral may not be retroactive. Thus, a salary reduction agreement can only apply deferrals of salary deferrals that have not yet been earned.

In a qualified cash or deferred election, the participant makes a choice for the employer to either pay the employee in cash or pay the amount to the plan, reducing the employee's salary.

### ELIGIBILITY

A CODA cannot require that a person complete more than one year of service or be older than 21 in order to make an elective deferral.

Therefore, the special 2-year rule under section 410(a)(1)(B)(i), which allows a plan to have a 2 year service requirement if participants are 100% vested upon entry into the plan, is not permitted for the CODA portion of the plan.

Note: Matching contributions and non-elective contributions as well as Profit Sharing contributions **can** apply the 2 years of service rule if participants become 100% vested upon entry into the plan. However, Qualified Matching Contributions and Qualified non-elective contributions, as defined under section 1.401(k)-1(g)(13) must be treated as elective contributions, i.e., must be:

- fully vested when contributed and
- subject to the same distribution restrictions as elective deferrals.

### **COVERAGE AND PARTICIPATION**

The CODA portion of the plan, by itself, must satisfy one of the coverage tests set forth in IRC § 410(b), either the ratio percentage test or the average benefits test.

Section 410(b) requires the plan to meet one of the following:

- (a) plan must benefit at least 70% of the employees of the employer or
- (b) the plan benefits:
  - (i) a percentage of employees who are not HCEs
  - (ii) who constitutes at least 70% of the percentage of HCEs benefiting under the plan, or
- (c) the plan meets the requirements of paragraph 2 (the average benefits test).

Section 410(b)(2) Average Benefit Percentage Test is satisfied if

- (i) plan benefits such employees as qualify under a classification set up by the ER and found by the IRS not to be discriminatory and
- (ii) the average benefit percentage for EEs who are not HCEs is at least 70% of the average benefit percentage for HCEs.

**TREASURY REGULATION 1.410(B)-7 DEFINITION OF PLAN AND RULES GOVERNING PLAN DISAGGREGATION AND AGGREGATION.**

- ❖ Treasury Regulation 1.410(b)-7(c) provides that the portion of a plan that is a section 401(k) plan and the portion that is not a section 401(k) plan are treated as separate plans for purposes of section 410(b).
- ❖ Similarly, the portion of a plan that is section 401(m) plan and the portion that is not a section 401(m) plan are treated as separate plans for purposes of section 410(b).

Thus, a plan that consists of:

- ❑ elective contributions under a section 401(k) plan,
- ❑ employee and matching contributions under a section 401(m) plan and
- ❑ Employer contributions other than elective, employee, or matching contributions

are treated as three separate plans for purposes of section 410(b).

Thus, if the plan provides for all three types of contributions, sections 1.410(b)-3, -6(f), and -7(c) could require an employer to run **three** separate 410(b) tests,

- ❑ one for the one for the (k) portion,
- ❑ one for the (m) portion and
- ❑ one for the profit sharing portion),

all of which could have different results.

- ❖ T.R 1.410(b)-7(d) states that for purposes of applying the ratio percentage or the nondiscriminatory classification test, an employer may designate **two or more separate plans as a single plan**. Note that the plans must be treated as a single plan for all purposes under section 401(a)(4) and 410(b).

**SECTION 1.410(b)-3 EMPLOYEES AND FORMER EMPLOYEES WHO BENEFIT UNDER THE PLAN.**

**Special benefiting rule for section 401(k)**

The following explains the rules of section 410(b) with respect to which employees must be:

- Included,
- Excluded, and
- Benefiting

under the plan. A clear understanding of these definitions and classifications is of utmost importance for an Agent when reviewing the Employer's coverage tests.

In determining whether the coverage tests have been satisfied, there is a special § 401(k) coverage rule for qualified CODAs. Under this rule, the CODA counts each person who is eligible to make an elective contribution ("EC") as benefiting, regardless of whether the employee actually elected to make deferrals.

(Note that a nonqualified CODA may not use this special benefiting rule.)

Section 1.410(b)-3(a)(1) provides the general benefiting rule for defined contribution plans.

An employee is treated as benefiting for a plan year if the employee receives an allocation taken into account under section 1.401(a)(4)-2(c)(2)(ii).

Section 1.410(b)-3(a)(2) provides exceptions to benefiting requirement for (k) and (m) plans. An employee is treated as benefiting under a section 401(k) plan if and only if the employee is an eligible employee under the plan as defined in 1.401(k)-1(g)(4). Similarly, an employee is treated as benefiting under a section 401(m) plan for a plan year if and only if the employee is an eligible employee defined in section 1.401(m)-1(f)(4) for the plan year.

Sections 1.401(k)-1(g)(4) define the term "eligible employee" as an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. An employee is considered eligible even though the employee did make elective deferrals because of:

- ❑ a suspension due to a loan or distribution or
- ❑ an election not to participate.

Similarly, section 1.401(m)-1(f)(4) defines the term eligible employee as an employee who is directly or indirectly eligible to make a employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures under the plan for a plan year. An employee is considered eligible even though the employee did not make employee contributions or receive matching contributions because of:

- ❑ a suspension due to a loan or distribution or
- ❑ an election not to participate.

More simply put, if an employee may participate in the CODA (and Employer Match, if applicable) that employee will be considered both eligible and benefiting for purposes of 410(b). This is true even if the employee made no deferrals during the year and correspondingly, received no employer match.

Oddly enough, this makes sense since the decision not to actually receive a monetary benefit was the employees and not that of the employers. But, remember, the plan still must pass the ADP/ACP tests and those employees deferring nothing will be included (their ADP & ACP ratios will both be 0%).

### **Disregarding employees**

In general, a qualified plan may prohibit employees from entering the plan prior to the attainment of age 21 and the completion of one year of service (see § 410(a)).

An employer that allows employees to enter the plan earlier (e.g., age 18) may choose separate testing under which all employees who have not met the statutory age and service entry maximums are disregarded. However, the plan must satisfy the nondiscrimination rules taking into account only those covered employees whose age and service are less than the statutory age and service maximums.

In other words, it's as if the employer had two plans, one containing covered employees who satisfy the maximum age and service requirements under § 410(a) and one containing covered employees who don't.

Section 1459 of SBJPA added § 401(k)(3)(F) and § 401(m)(5)(C) to the Code to provide a special rule for early participation. Congress believed that some employers were reluctant to include younger or new employees in a section 401(k) plan because these employees tended to have lower deferral percentages and therefore could cause the plan to fail the ADP (and ACP) test under the rule above.

To encourage coverage of these employees, effective for plan years beginning after December 31, 1998, an employer may elect to disregard employees (other than HCEs) eligible to participate in the plan before they have completed one year of service and reached age 21,. However,

- the plan must separately satisfy the minimum coverage rules of § 410(b) taking into account only those employees who have not completed one year of service or are under age 21, and.
- A single ADP test is applied that compares the ADP for all eligible HCEs (including those that don't meet the statutory age and service requirements) with the ADP for eligible NHCEs who have completed one year of service and reached age 21. A similar rule applies for purposes of the ACP test.

**SECTION 1.410(B)-6 EMPLOYEES WHO CAN BE DISREGARDED (EXCLUDABLE)  
FOR SECTION 401(b)**

**Introduction, section 1.401(b)-6(a)**

Section 1.410(b)-6(a) provides that all employees of the employer, other than the excludable employees described in paragraphs (b) through (i) of this section, are taken into account when applying section 410(b).

**Minimum age and service employees, section 1.401(b)-6(b)**

Section 1.410(b)-6(b) excludes all employees who are don't meet the minimum age and service conditions under section 410(a) if a plan excludes such employees and these employees do not benefit under the plan.

**Certain nonresident aliens, 1.410(b)-6(c)**

An employee who is a nonresident alien (under section 7701(b)(1)(B) and who receives no earned income (within the meaning of section 911(d)(2) from the employer that constitutes income from sources within the United States is treated as an excludable employee. There is also a special treaty rule.



**Collectively bargained employees, 1.410(b)-6(d)**

A collectively bargained employee is an excludable employee with respect to a plan that benefits solely noncollectively bargained employees. Also, if a plan benefits both collectively bargained and noncollectively bargained employees, the portion of the plan that benefits collectively bargained employees is disaggregated from the other portion under section 1.410(b)-7(b).

**Employees of qualified separate lines of business-1.401(b)-6(e)**

If an employer is treated as operating qualified separate lines of business under section 1.414(r)-1(b), in testing the plan that benefits employees of one qualified separate lines of business, the employees of the other qualified separate lines of business are treated as excludable.

**Certain terminating employees, 1.401(b)-6(f)**

Section 1.410(b)-6(f) provides that certain terminating employees may be disregarded (treated as excludable employees) for a plan year if all the following conditions are met:

- (i) The employee does not benefit under the plan for the plan year
- (ii) The employee is eligible to participate in the plan,
- (iii) The plan has a

- minimum period of service requirement, or
- a requirement that an employee be employed on the last day of the plan year

in order for an employee to receive an allocation for the plan year,

- (iv) The employee fails to receive an allocation under the plan solely because of the failure to satisfy the minimum period of service or last –day requirement, and
- (v) The employee terminates employment during the plan year with no more than 500 hours of service, and the employee is not an employee as of the last day of the plan year.

**Other excludable employees under 1.410(b)-6(g)-(i)**

Employees of certain governmental or tax exempt entities, as well as certain former employees are treated as excludable.

**AUDIT HINTS**

In order to review the Employer provided 410(b) coverage tests accurately, the Agent should first verify that **all employees** that had at least 1 YOS and were 21 years old were considered Eligible Employees and were not excludable under the other categories.

This means that any group(s) of employees that were carved out of coverage by the Employer (ie hourly or clerical employees—other than excludable employees) should not be disregarded for coverage purposes, they are considered Eligible. Thus, they are included in the coverage testing, even though these employees do not benefit under the plan.

The Agent must also determine which employees that terminated during the year should be considered eligible. Normally, it would be those with > 500 HOS. **However, in a (k) and (m) plan this is not the case. If the employees were eligible for any portion of the year, they are considered eligible (as well as benefiting).**

The next step would be for the Agent to properly note which employees benefited under the plan such as those employees who received a dollar allocation. However, for a (k) and (m) plan, eligible employees are benefiting even if they do not receive a dollar benefit, but were eligible to make elective deferrals.

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**Example 1:**

Prestigious Law Firm sponsors two 401(k) plans,

- one covering partner and support staff (#001) and
- one that covers only associates attorneys (#002).

The eligibility requirements for both plans are 1 YOS and age 21.

In order to receive a profit sharing contribution, the employee must be employed on the last day of the plan year.

The match is made at the time of the employee deferral.

**Employee Plans CPE Topics For 2002**

For 1999, the employer, Prestigious, made both a match and a profit sharing contribution to plan 001. The only contributions made to plan #002 were employee deferrals.

As of the 12-31-99 the Employee Census reflected the following:

- 130 active employees
- 95 active participants
- 20 terminated participates of which 10 worked > 500 hours.

The **130 active employees** were composed of the following:

40 Partners, all HCEs

40 Support Staff, all NHCEs, 10 of which had less than 1 YOS

50 Associates, the majority are NHCEs, 25 of which had less than 1 YOS. Thus, the total employees are 130.

The **95 active participants** were composed of the following:

40 Partners

30 Support Staff

25 Associates, 5 of which were HCEs and 20 of which were NHCEs

The terminated Employees were composed of the following

2 Partners, both HCEs	1 had > 500 hours
8 Support Staff	3 had > 500 hours
10 Associates	6 had > 500 hours, of those 2HCEs
<b>Total of 20</b>	<b>Total 10</b>

**Points to remember for determining eligible and benefiting employees:**

- For purposes of applying section 410(b) all employees, other than the excludable employees (such as those that do not meet Age and Service, and Certain Terminating Employees) are taken into account.
- An employee is treated as benefiting under a section 401(k) and (m) plan if the employee is an eligible employee.

## Employee Plans CPE Topics For 2002

For the (k) feature, an eligible employee is one that is eligible to make a cash or deferred election under the plan for all or a portion of the plan year.

For the (m) feature, an eligible employee is one that is eligible to receive an allocation of matching contributions

- An employee may be treated as an excludable employee if the employee was eligible to participate but does not benefit because the plan had a minimum period of service or a requirement that an employee be employed on the last day of the plan year to receive an allocation and the employee terminated employment during the plan year with no more than 500 hours of service.

### **EXPLANATION FOR PLAN 001, (K)-FIRST, TEST PLAN #001 SEPARATELY.**

Review the three tables below (one for the (k), one for the (m) and one for the P/S portion of the plan).

#### **First determine who is eligible and excludable under the plan**

The excludable employees are:

- 10 Support Staff (had less than 1 year of service)
- 25 Associates (had less than 1 year of service)  
35

The **eligible** employees (not necessarily benefiting under Plan 001) are:

- 40 partners
- 30 support staff
- 25 Associates
- 20 Terminating employees  
115 eligible employees

**ELIGIBLE NHCEs AND HCEs**

The eligible NHCEs and HCEs are those employees who cannot be excludable under section 1.401(b)-6. Note the for k plans, there is no termination exclusion if the participants are eligible for any part of the year. Also note that eligible employees also include those employees who may be excluded from participating in the plan..

**Eligible HCEs under the example**

The following are all eligible HCEs:

- 40 Active Partners
- 5 active associates
- 2 terminating partners (all terminating HCEs are eligible since termination exclusion under 1.410(b)-6(f) does not apply to k plans
- 2 terminating associates (even not participants in Plan 001.

49 total eligible HCEs

**Eligible NHCEs under the Example**

- 30 Active support staff
- 20 active associates,
- 8 terminating support staff, and
- 8 terminating associates

66 total NHCEs

**PLAN 001—EMPLOYEES WHO BENEFIT UNDER THE PLAN--PARTNERS AND SUPPORT STAFF**

- 40 partners and 30 support staff of the active employees, and
- 2 partners and 8 support staff of the terminating employees

**Benefiting HCEs**

The total HCEs **who are benefiting** under plan 001 are 42 partners (40 active and 2 terminating)

**Benefiting NHCEs**

The NHCEs who are benefiting are:

38 support staff (30 active and 8 terminating).

**DETERMINING THE RATIO PERCENTAGE OF HCEs AND NHCEs**

**(k)**

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
<b>TOTAL</b>	40(P)+30(S)+25(A)+20(T)	40+30+2(TP)+8(TS)	
<b>HCE</b>	40(P)+5(A)+2(TP)+2(TA)	40+2(TP)	42/49=86%
<b>NHCE</b>	30+20+8(TS)+8(TA)	30+8(TS)	38/66=58%

RESULTS (NHCE%/HCE%) 58/86=67 (must be  $\geq$  70% to pass coverage).

THE (K) PLAN FAILS the ratio percentage test.

**(m)**

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
<b>TOTAL</b>	40(P)+30(S)+25(A)+20(T)	40+30+2(TP)+8(TS)	
<b>HC</b>	40(P)+5(A)+2(TP)+2(TA)	40+2(TP)	42/49=86%
<b>NHC</b>	30+20+8(TS)+8(TA)	30+8(TS)	38/66=58%

RESULTS (NHCE%/HCE%) 58/86=67 (must be  $\geq$  70% to pass coverage). THE (M) PLAN FAILS

**PROFIT SHARING PLAN**

**First determine who is eligible and excludable under the plan**

Remember, for this example, there are additional excludable employees for the profit sharing element since the terminating employees with less than 500 hours are considered to be excludable.

The excludable employees are:

- 10 Support Staff (had less than 1 year of service)
- 25 Associates (had less than 1 year of service)
- $\frac{10}{45}$  terminating employees

The **eligible** employees of Plan 001 are:

- 40 active partners
- 30 support staff
- 25 active Associates
- $\frac{10}{105}$  Terminating employees  
eligible employees

### ELIGIBLE NHCEs AND HCEs

The eligible NHCEs and HCEs are those employees who cannot be excludable under section 1.401(b)-6.

#### **Eligible HCEs under the example**

The following are all eligible HCEs:

- ❑ 40 Active Partners
- ❑ 5 active associates
- ❑ 1 terminating partners (all terminating HCEs are eligible since termination exclusion under 1.410(b)-6(f) does not apply to k plans
- ❑ 2 terminating associates (even not participants in Plan 001).

48 total eligible HCEs

**Eligible NHCEs under the Example**

- 30 Active support staff
- 20 active associates,
- 3 terminating support staff, and
- 4 terminating associates

57 total NHCEs

**Benefiting HCEs**

There is an assumption that all terminating employees were not present on the last day of the plan year.

The total HCEs **who are benefiting** under plan 001 are 40 partners (40 active).

**Benefiting NHCEs**

The NHCEs who are benefiting are:

30 support staff (30 active).

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
<b>TOTAL</b>	40(P)+30(S)+25(A)+10(T)	40+30	
<b>HCE</b>	40(P)+5(A)+1(TP)+2(TA)	40	40/48=83%
<b>NHCE</b>	30+20+3(TS)+4(TA)	30	30/57=53%

RESULTS (NHCE%/HCE%) 53/83=64 (must be  $\geq$  70% to pass coverage). THE (P/S) PLAN FAILS

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**Example 2:**

Now assume in this example the Employer elects to treat the two plans as one under 1.410(b)-(7). Complete the three tables below (one for the (k), one for the (m) and one for the P/S portion of the plan).

Now all eligible employees and all benefiting employees are combined to run the coverage tests.



Employee Plans CPE Topics For 2002

**(k)** (Revised 2<sup>nd</sup> Time)

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
TOTAL	40(P)+30(S)+25(A)+20(T)	40+30+25+20	115/115
HCE	40(P)+5(A)+2(TP)+2(TA)	40+5+2+2	49/49=100%
NHCE	30+20+8(TS)+8(TA)	30+20+8+8	66/66=100%

RESULTS (NHCE%/HCE%)  $100/100=100\%$  (must be  $\geq 70\%$  to pass coverage).  
The (k) portion of the Plan now passes.

**(m)** (Revised 2<sup>nd</sup> Time)

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
TOTAL	40(P)+30(S)+25(A)+20(T)	40+30+25+20	115/115
HCE	40(P)+5(A)+2(TP)+2(TA)	40+5+2+2	49/49=100%
NHCE	30+20+8(TS)+8(TA)	30+20+8+8	66/66=100%

RESULTS (NHCE%/HCE%)  $100/100=100\%$  (must be  $\geq 70\%$  to pass coverage).  
The (m) portion of the Plan now passes.

**(P/S)** (Revised 2<sup>nd</sup> Time)

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
TOTAL	40(P)+30(S)+25(A)+10(T)	40+30	70/105
HCE	40(P)+5(A)+1(TP)+2(TA)	40	40/48=83%
NHCE	30(S)+20(A)+3(TS)+4(TA)	30	30/57=53%

RESULTS (NHCE%/HCE%)  $53/83=64\%$  (must be  $\geq 70\%$  to pass coverage).  
The P/S portion of the Plan still Fails

**Example 3**

Still testing the two plans as one but now assume that the plan requires two years of service for a participant to receive a profit sharing contribution. Also assume that 2 of the Support Staff and 13 of the Associate Attorneys that were previously eligible for a Profit Sharing allocation had less than 2 YOS. This additional information will not result in a change to either the (k) or (m) tests, but will require modifications to the P/S test.

**P/S** (Revised 3<sup>rd</sup> Time)

	<b>ELIGIBLE</b>	<b>BENEFITING</b>	<b>% = BEN/ELIG</b>
TOTAL	40(P)+28(S)+12(A)+10(T)	40+28	68/90
HC	40(P)+5(A)+1(TP)+2(TA)	40	40/48=83%

<b>NHC</b>	28(S)+12(A)+3(TS)+4(TA)	28	28/47=60%
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RESULTS (NHCE%/HCE%) 60/83=72 (must be  $\geq$  70% to pass coverage). The P/S plan now passes.

Note that either plan does not have to satisfy the ratio percentage test in order to pass coverage. The plan can also satisfy the average benefits test.

## COMPENSATION

### DEFINING COMPENSATION UNDER SECTION 414(S)

Section 401(K)(9) defines compensation as the meaning provided by section 414(s). Below is a summary of some of the various compensation definitions provided by section 414(s):

Section 1.414(s) – 1(c)(2) of the Regulations includes all the 1.415-2(d) items which satisfy the nondiscrimination requirements. Plans using this definition would not have to submit a demonstration with a determination application (“Demo 9”) that the compensation definition is nondiscriminatory.

Section 1.414(s) – 1(c)(3) provides an alternative safe harbor definition – the Demo 9 showing the definition is nondiscriminatory is not required. Compensation is defined as paragraph (c)(2) compensation reduced by all of the following items;

- reimbursements or other expense allowances,
- fringe benefits,
- moving expenses,
- deferred compensation, and
- welfare benefits.

Section 1.414(s) – 1(d) provides rules for using alternative definitions of compensation that satisfy section 414(s) as long as the definition does not by design favor HCE and is *reasonable* and meets the *nondiscrimination requirements* (Demo 9 is required).

Section 1.414(s)(e) and (f) provides rules for the use of rate of compensation, prior-employer compensation and imputed compensation rather than actual compensation.

**SECTION 415(c)(3) COMPENSATION**

The first two definitions contained in the 414(s) regulations are based on section 415(c)(3) compensation. The following items satisfy 415(c)(3) and are provided in 1.415-2:

- ❖ Section 1.415-2(d)(2) & (3). Section 1.415-2(d)(2) provides that compensation includes employee's:
  - wages,
  - salaries,
  - fees for professional services, and
  - other amounts received for personal services actually rendered in the course of employment to the extent that the amounts are includible in gross income. This section provides examples of other items that are includible in income
- ❖ Section 1.415-2(d)(3) goes on to note what is not includible in compensation, such as:
  - Contributions made to a deferred compensation plan that are not includible in income (before the application of 415 to that plan)
  - Amounts realized from the exercise of non-qualified stock option,
  - Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option, and
  - Other amounts which receive special tax benefits.
- ❖ Section 1.415 – 2(d)(10) 415 safe-harbor lists all items of inclusion as defined by section 1.415-2(d)(2)(i) and excludes all items listed in paragraph section 1.415-2(d)(3)
- ❖ Section 1.415 –2(d)(11) gives alternative definitions
  - (i) Information required to be reported under section 6041 (*covers 1099's*), 6051 (*covers W-2's*), 6052 (*group term life insurance*). Compensation is defined as

- wages within the meaning of section 3401(a) (*relates to wages subject to withholding*) and
- all other payments of compensation to an employee by the employer (in the course of the employer's trade or business) for which the employer is required to furnish the EE a written statement under sections 6041(d) and 6051(a).

This definition may be modified by deductible reimbursed moving expenses.

- (ii) Section 3401(a) wages. Compensation is defined as wages within the meaning of section 3401(a).

### **SBJPA changed definition of 415(c)(3) compensation**

SBJPA added section 415(c)(3)(D) which provides that effective January 1, 1998, participant compensation includes

- (i) any elective deferral (402(g)), and
- (ii) any amount which is contributed or deferred by the employer at the election of the employee and which is not includible in the gross income of the employee by reason of sections 125 or 457.

This affected 414(s) in that the employer must **elect not** to include these amounts. Prior to SBJPA they had to elect to include the amounts.

### **Section 125 and 457 plans**

A section 125 Plan, also known as a Cafeteria Plan, allows the participant to choose among two or more benefits consisting of cash and qualified benefits without having to include any of the derived benefit in gross income. The benefits offered, such as group term life, coverage under a dependent care assistance program or coverage under an accident, health or legal plan must also be excludable from gross income under a specific section of the Code, otherwise they do not meet the qualified benefit definition.

A section 457 Plan is a deferred compensation plan sponsored by state and local governments or tax exempt organizations.

**EXAMPLE 1:**

The Employer, We Do it Write Printing Company, maintains a section 401(k) Profit Sharing Plan as well as a section 125 Cafeteria Plan. The Plan Document for the year under audit, 199912, for the Profit Sharing Plan provides that Participants may defer up to 15% of Compensation.

Compensation for purposes of section 401(k)(9) and nondiscrimination testing was defined by the Plan Document as section 3401(a) wages.

Compensation also includes

- (i) any elective deferral (section 402(g)) and
- (ii) any amount which is contributed or deferred by the Employer at the election of the employee and is not includible in the gross income of the employee by reason of sections 125 or 457.

Assume the Plan used the current year testing method:

- What documents would you request to determine that section 402(g) limits were not exceeded?
- What documents would you request to determine that Participant deferrals were in compliance with the Plan Document?
- What documents would you request to determine that in operation the Plan was using the compensation definition contained in the Plan Document?

1999 ADP Test using current year data.

Plan passes since ADP for the NHCEs is > than the ADP for the HCEs

HCE	Compensation	Deferral	ADP
Eric Davis	\$160,000	\$10,500	6.56%
Tiffany Clarke	\$160,000	\$10,000	6.25%
<b>Total Percentage</b>			<u>12.81</u>

**HCE ADP = 6.41 (12.81/2)**

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<b>NHCE</b>	<b>Compensation</b>	<b>Deferral</b>	<b>ADP</b>
<b>Jay Jacob</b>	\$61,780	\$7,118	11.52%
<b>Emily Koplín</b>	\$45,428	\$4503	9.91%
<b>Ross Tipping</b>	\$95,567	\$10,000	10.46%
<b>Carol Rodriguez</b>	\$86,523	\$848	9.80%
<b>Felica Valentine</b>	\$25,100	\$0	0.00%
<b>Total Percentage</b>			<u>41.69%</u>

**NHCE ADP = 8.34 (41.69/5)**

After obtaining the ADP and 1999 W-2's you perform the following audit steps.

1. Review the ADP Test to verify that Participant deferrals were equal or less than the section 402(g) limit and the percentage deferred was equal to or less than 15%, and
2. Compare Compensation reflected on the ADP Test to W-2 wages.

### **Findings**

Compensation on the ADP test was incorrect for

J. Jacobi

E. Koplín

R. Tipping, and

Carol Rodriguez.

For the first three employees, the section 125 amount was counted twice.

For C. Rodriguez, both her section 125 amount and deferrals were counted twice. .

Eric Davis deferred \$500 more than permitted by 402(g).

**What should be done?**

Have employer re-run the test using correct compensation figures.

Verify that \$500 was refunded to Eric Davis by April 15, 2000.

What documents would you request?

A copy of the cancelled distribution check and a copy of Form 1099.

***Revised Test (1<sup>st</sup> Time)***

Plan still passes since ADP for the NHCEs is > than the ADP for the HCEs

HCE	Compensation	Deferral	ADP
Eric Davis	\$160,000	\$10,500	6.56%
Tiffany Clarke	\$160,000	\$10,000	6.25%
<b>Total Percentage</b>			<u>12.81</u>

**HCE ADP = 6.41 (12.81/2)**

NHCE	Compensation	Deferral	ADP
Jay Jacob	\$61,480	\$7,118	11.57%
Emily Koplín	\$45,228	\$4,503	9.96%
Ross Tipping	\$95,067	\$10,000	10.52%
Carol Rodriguez	\$85,275	\$848	9.94%
Felica Valentine	\$25,100	\$0	0.00%
<b>Total Percentage</b>			<u>41.69%</u>

**NHCE ADP = 8.40 (41.99/5)**

**NOTICE 97-45 –**

**SIMPLIFIED DEFINITION OF HCE UNDER SBJPA**

Section 1431 of the Small Business Job Protection Act of 1996, ("SBJPA") amended section 414(q)(1) effective for plan years beginning after December 31, 1996 to provide that an HCE is 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 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.

Pursuant to section 414(q)(3), an employee is in the top-paid group for any year if the employee is in the group consisting of the top 20 percent of the employees of the employer when ranked on the basis of compensation paid to employees during such year.

Thus if a "top paid group election" referred to this notice is made, an employee (who is not a 5-percent owner) who has compensation in excess of \$ 80,000 **is not an HCE** if the employee is not a member of the top-paid group.

**PRIOR AND CURRENT YEAR TESTING**

**Current Year Testing (Chapter 3 of 2001 CPE Text)**

For plan years beginning before January 1, 1997, the HCE ADP was compared to the NHCE ADP for the same year (the testing year). This methodology is known as "**current year**" testing.

**Prior Year Testing**

Act section 1433(c) of SBJPA amended section 401(k)(3)(A) (and section 401(m)(2)(A), for the ACP test) so that, for plan years beginning after December 31, 1996, unless the employer elects to use current year testing, the HCE ADP (and ACP, if applicable) for a testing year is compared to the NHCE ADP (and ACP) for the prior year. This methodology is known as "**prior year**" testing.



The individuals taken into account in determining the prior year's ADP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individual's status in the current year. A special rule applies for the first plan year.

In the case of the first plan year of any plan (other than a successor plan), the amount taken into account as the ADP or ACP for NHCEs for the preceding plan year is deemed to be 3 percent, unless an election is made to use the actual ADP and ACP data for the first plan year.

### **CHANGING TESTING METHOD (CHAPTER 3 OF CPE FOR 2001)**

A plan that uses the prior year testing method may adopt the current year testing method for any subsequent testing year. Notification to or prior approval of the Service is not required for the election to be valid. However, the employer may wish to apply for a determination letter on the plan amendment needed to implement the change.

A plan that uses current year testing after the 1997 plan year (see Notice 97-2) is permitted to change to prior year testing in four situations only:

1. The plan is not the result of the aggregation of two or more plans, and current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years the plan has been in existence).
2. The plan is the result of the aggregation of two or more plans, and for each of the aggregated plans current year testing was used for each of the 5 plan years preceding the year of the change (or, if lesser, the number of years the plan has been in existence).
3. A transaction occurs that is described in section 410(b)(6)(C)(i) (i.e., the employer becomes or ceases to be a member of a section 414(b), (c), (m) or (o) group), and, as a result, the employer maintains both a plan using prior year testing and a plan using current year testing, and the change occurs within the transition period described in section 410(b)(6)(C)(ii) (i.e., by the last day of the 1st plan year beginning after the transaction).
4. The change occurs within the plan's SBJPA remedial amendment period (generally, the last day of the first plan year beginning on or after January 1, 2001; see Rev. Proc. 2000-27, 2000-26 I.R.B. 1272).

Notification to or prior approval of the Service is not required for the change to be valid. However, the employer may wish to apply for a determination letter on the plan amendment needed to implement the change.

**PLAN PROVISIONS REGARDING TESTING METHOD (CHAPTER 3 OF CPE FOR 2001)**

A plan must specify which of the two testing methods (current year or prior year) it is using. If the employer changes the testing method under a plan, the plan must be amended to reflect the change.

The regulations under section 401(k) and (m) permit a plan to incorporate by reference the ADP and ACP tests (sections 401(k)(3) and (m)(2), and, if applicable, (m)(9)) and the underlying regulations. A plan that incorporates these provisions by reference may continue to do so, but must specify which of the two testing methods (current year or prior year) the plan is using. Further, for purposes of the first plan year rule, a plan that incorporates these provisions by reference must specify whether the ADP/ACP for NHCEs is 3% or the current year's ADP/ACP.

Rev. Proc. 2000-27 extends the remedial amendment period for SBJPA generally to the last day of the first plan year beginning on or after January 1, 2001. Please note that Rev. Proc. 2001-55 extends the GUST remedial amendment period under Section 401(b) of the Code for qualified retirement plans.

Any plan amendments to reflect a choice in testing method are not required to be adopted before the end of this remedial amendment period. However, plans must be operated in accordance with the SBJPA changes as of the statutory effective date (section 1433(c) and (d), which added the prior year testing method, were effective for plan years beginning after December 31, 1996). In addition, any retroactive amendments must reflect:

the choices made in the operation of the plan for each testing year, including the choice of testing method (and any changes to that method), and

the date(s) on which the plan began to operate in accordance with those choices (and any changes).

In summary, with respect to Prior vs. Current Year Data effective for plan years beginning after December 31, 1996, prior year data must be used in determining the ADP of NHCEs while current year data is used for HCEs. However, an Employer may elect to use current year data for determining the ADP for both HCEs and NHCE under certain circumstances. Effective 1-1-02, Section IX of

Notice 98-1 requires a plan document to specify whether current year or prior year data will be used.

**CLASSIFYING THE EMPLOYEES AS HCE/NHCEs AND APPLYING THE ADP TEST**

To see how the new definition of HCEs effects the ADP test, for plan years beginning after December 31, 1996, consider the following example.

**EXAMPLE 1: Illustrating Definition of HCE**

During 1998 Abbie was considered an HCE and Bobbie was an NHCE. During 1999, Abbie terminates employment on 2-1-99 and Bobbie gets a promotion.

For 1999, Abbie's W-2 wages were \$30,000 while Bobbie's were \$100,000.

Bobbie does not become an HCE in 1999 even though she earns \$100,000 in 1999. Abbie will still be considered an HCE in the computation of the 1999 HCE ADP even though she only earned \$30,000 and Bobbie will still be considered an NHCE for 1999 since determination of HCE status is based on the preceding years status not the individuals status in the current year.

For a Plan that uses prior year data in 1999, the HCE determination is based on 1998 compensation. **The NHCE classifications on the ADP test would be based on 1997 compensation.**

**EXAMPLE 2: Exam tip**

Using the previous ADP example, if you are on audit, in looking over the ADP test and the W-2 compensation, you may notice that:

Abbie is classified as an HCE even though her 1999 W-2 wages were \$30,000, and

Bobbie is classified as an NHCE even though she earned \$100,000 in 1999.

What audit steps would you take to determine that the HCE/NHCE classification noted on the ADP Test provided was correct?

In general, the ADP Test is reviewed and any unusual classifications are noted. Therefore, the agent may want to follow up and request copies of the 1998 W-2s to determine that the HCE/NHCE classifications were performed correctly.

**HOW CLASSIFYING NHCEs/HCEs RELATE TO THE ADP/ACP TEST**

When running the ADP/ACP test, the first step is to classify whether an employee is an HCE or NHCE. For a plan using the current year method:

The NHCEs and HCEs are classified in the prior year (with respect to the compensation limit) and

The ADP for both the NHCEs and HCEs are calculated in the current year.

**Example 3**

The Roscoe Milling Company sponsors a 401(k) plan and has the following employees. All employees were eligible to make elective deferrals and the plan did not make the top paid group election. The plan is on a calendar year. The testing year is 1999 and the plan uses the current year method.

Since the plan uses the current year method, the HCE/NHCE classification is based on the prior calendar year, 1998. Assume that there are no 5% owners.

Name	1998 Compensation	HCE/NHCE (Classified by employer)
Ross Tipping	\$90,100	HCE
Eric Davis	\$145,000	HCE
Tiffany Clarke	\$150,000	HCE
Jay Jacobi	\$61,480	NHCE
Emily Koplín	\$40,118	NHCE
Carol Rodriguez	\$85,275	HCE
Felica Valentine	\$25,100	NHCE

**EXAMPLE 3:**

Now assume that the ER provides the requested 1998 W-2's. Box 5 earnings for Ross Tipping are \$82,000, for Carol Rodriguez her earnings were \$75,000. What should be done now?

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Based on this information it appears that the Employer needs to re-run the test again reflecting **Carol Rodriguez** as an NHCE.

Name	1998 Compensation	HCE/NHCE (correct classification)
Ross Tipping	\$90,100	HCE
Eric Davis	\$145,000	HCE
Tiffany Clarke	\$150,000	HCE
Jay Jacobi	\$61,480	NHCE
Emily Koplín	\$40,118	NHCE
Leah Levine	\$0 (Left in 1997)	N/A
Adam Sands	\$0 (Left in 1997)	N/A
Carol Rodriguez	<b>\$75,000</b>	<b>NHCE</b>
Felica Valentine	\$25,100	NHCE

Revised Test

Now that the HCEs/NHCEs are correctly identified, now have to determine whether the ADP/ACP test was run correctly by using the current year data for NHCEs and HCEs for both 1999. Thus, for the above employees, have to determine the ADP percentages using the **1999** compensation and **1999** deferrals.

Plan passes since ADP for the NHCEs is greater than the ADP for the HCEs

<u>HCE</u>	1999 Compensation	1999 deferral	ADP
Ross Tipping	\$95,067	\$10,000	10.52%
Eric Davis	\$160,000	\$10,500	6.56%
Tiffany Clarke	\$160,000	\$10,000	6.25%
<b>Total ADP %</b>			<b><u>23.33%</u></b>

**HCE ADP = 7.78 (23.33/3)**

<u>NHCE</u>	1999 Compensation	1999 deferral	ADP
Jay Jacobi	\$61,480	\$7,118	11.57%
Emily Koplín	\$45,228	\$4,503	9.96%
Carol Rodriguez	\$85,275	\$848	9.94%
Felica Valentin	\$25,100	\$-0-	0.00%
<b>Total ADP %</b>			<b><u>31.47%</u></b>

**NHCE ADP = 7.87 (31.47/4)**

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Note that even though Carol Rodriguez earned over \$80,000 for 1999, she is not an HCE for 1999 since her earnings during the relevant testing year for HCE/NHCEs was \$80,000 or less. However, her actual deferral percentage is based on 1999 data.

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**EXAMPLE 4:**

Using the above example as “Revised”, assume that the plan instead used prior year method to satisfy the ADP/ACP test. First, to determine if the HCE classification for 1999 was correct the agent would still obtain **1998 W-2’s**.

In order to verify that the 1998 (prior year) ADP Test properly classified HCEs and NHCEs and accordingly compute the correct NHCEs 1998 ADP (the basis for 1999 testing) what information would you request? You would request the **1997 W-2s** to see who is an NHCE so that the 1998 NHCE ADP.

<b>Name</b>	<b>1997 Compensation</b>	<b>HCE/NHCE classification</b>
<b>Ross Tipping</b>	\$82,000	HCE
<b>Eric Davis</b>	\$125,000	HCE
<b>Tiffany Clarke</b>	\$110,000	HCE
<b>Jay Jacobi</b>	\$0 (was not employed)	NHCE
<b>Emily Koplín</b>	\$35,000	NHCE
<b>Leah Levine</b>	\$90,000	HCE
<b>Adam Sands</b>	\$50,500	NHCE
<b>Carol Rodriguez</b>	\$82,000	HCE
<b>Felica Valentine</b>	\$20,000	NHCE

**1998 NHCE ADP**

<b>Name</b>	<b>1998 Compensation</b>	<b>1998 deferral</b>	<b>ADP</b>
<b>Jay Jacobi</b>	\$61,480	\$5,000	N/A
<b>Emily Koplín</b>	\$40,118	\$2,000	4.9%
<b>Adam Sands</b>	\$0 (Left in 1997)	\$0	0%
<b>Felica Valentine</b>	\$25,100	\$500	2%

The 1998 NHCE ADP is 6.9%/4 or 1.725%

<b>HCE</b>	<b>1999 Compensation</b>	<b>1999 deferral</b>	<b>ADP</b>
<b>Ross Tipping</b>	\$95,067	\$10,000	10.52%
<b>Eric Davis</b>	\$160,000	\$10,500	6.56%
<b>Tiffany Clarke</b>	\$160,000	\$10,000	6.25%
<b>Total ADP %</b>			<u>23.33%</u>

**HCE ADP = 7.78 (23.33/3)**

Thus, this plan fails the ADP test, since 3.45% (the less of 2+ pr 2x the NHCE ADP) is less than 7.78%

**Explanation**

Carol Rodriguez was not considered as part of the ADP/ACP test. Specifically, she was not considered as part of the 1998 NHCE ADP because she was classified as an HCE for that 1997. In addition, she was not considered part of the 1999 HCE ADP because she was considered an NHCE since her compensation was \$80,000 or less.

In 1997, Carol earned \$82,000, so she was considered an HCE and not part of the 1998 NHCE ADP. To determine the 1999 HCEs, 1998 compensation is considered. In 1998, Carol was out on a leave of absence, so she earned \$75,000 and is classified as an NHCE for that year. Thus, she is not considered part of the 1999 HCE ADP.

Jay Jacobi was not considered as an NHCE since he had not started with the company until 1998. However, Adam Sands was considered part of the 1998 NHCE ADP since he was an NHCE in 1997. Finally, Leah Levine was not part of the 1999 HCE ADP. Although she was an HCE in 1997, she left in 1997 and was not employed in 1998 when the HCEs are classified.

At a minimum, the Employer should recalculate the 1998 ADP removing Carol Rodriguez from the NHCE ADP and add her to the 1999 HCE ADP calculation. For the next revision assume that Carol's 1999 compensation and deferrals were \$78,000 and \$8,000, respectively.

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**Revised Test (3<sup>rd</sup> time)**

The Plan still passes since the ADP for the HCEs is not greater than 8.98 (1.25 \* 7.18 (the 1998 ADP for the NHCEs))

<u>HCE</u>	Compensation	deferral	ADP
Ross Tipping	95,067	10,000	10.52
Eric Davis	160,000	10,500	6.56
Tiffany Clarke	160,000	10,000	6.25
Carol Rodriguez	78,000	8,000	<u>10.26</u>
			<u>33.59</u>

HCE ADP = 8.40 (33.59/4)

<u>NHCE</u>	Compensation	deferral	ADP
Jay Jacobi	61,480	7,118	11.57
Emily Koplín	45,228	4503	9.96
Felica Valentin	25,100	-0-	<u>0.00</u>
			<u>21.53</u>

NHCE ADP = 7.18(21.53/3)





## METHOD OF CORRECTION FOR ADP TEST

If the plan fails the ADP test, correction must be made by one of the three following methods:

- a. Distribution
- b. Recharacterization, or
- c. Contribution of Qualified Non-elective Contributions (QNECs) and Qualified Matching Contributions (QMACs).

### DISTRIBUTIONS

The Plan has 12 months after the end of the Plan Year to correct excess contributions. The plan may distribute excess contributions any time during the 12 month period. However, the Employer will be subject to a 10% excise tax under IRC section 4979 if the distributions are not made within 2½ months after the end of the plan year.

"Excess contributions" are the amount of contributions used to calculate the HCE ADP that **exceeds** the amount of such contributions permitted if the ADP test were passed.

Similarly, "excess aggregate contributions" are the amount of contributions used to calculate the HCE ACP that exceeds the amount of such contributions permitted if the ACP test were passed.

#### **Matching contributions must also be reduced**

**Caution:** If corrective distributions are made as a result of either the ADP Test or section 402(g) and a matching contribution was made on the deferrals distributed, the Plan is likely to be discriminatory (even if the Plan passed the ACP Test) if the matching contribution is not also reduced.

Without a reduction of the match, the employee (which in all probability will be a HCE) will have received a higher rate of match than any other employee. In order to correct for this situation, the vested matching contribution made on account of the excess deferral may be forfeited, but only if the Plan Document permits this forfeiture (sections 401(k)(8)(E) and 411(a)(3)(G)).

The forfeiture could be reallocated or used to reduce employer contributions. The Plan may also make corrective contributions to nonexcludible NHCEs. If an amendment is required to correct the excess match, the amendment must be adopted and implemented by the 15<sup>th</sup> day of the 10<sup>th</sup> month after the end of the Plan Year, see I.T.R 1.401(a)(4)-11(g).

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***EXAMPLE 1:***

The Plan provides that Participants may defer up to 15% of their compensation and that the Employer will make a matching contribution equal to 50% of the amount deferred.

Ms. Big, an HCE, deferred \$10,000 and accordingly received a \$5,000 match. Mr. Little, a NHCE deferred \$5,000 and received a \$2,500 match. Due to the Plan's failure of the ADP, a \$1,500 corrective distribution was made to Ms. Big. The Plan passed the ACP test therefore correction was not required based on the results of that test. However, without a reduction of the \$5,000 match received by Ms. Big the Plan is discriminatory since the rate of matching contributions  $59\%(5,000/8,500)$  for HCEs is greater than the rate for NHCEs  $50\%(2,500/5,000)$ .

**Leveling method for distributing excess contributions**

The amount of excess contributions (or excess aggregate contributions) is determined using a leveling method based on HCEs' ADRs (or ACRs), beginning with the HCE with the highest percentage and continuing in descending order of ADR (or ACR) percentages until the target HCE ADP (or ACP) is reached.

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***EXAMPLE 2:-Determining excess contributions***

During 2001 the auditor was assigned the 199912 401(k) plan for House Painting USA, Inc. At the initial appointment, the POA revealed that during his preparation for the audit, he discovered that the prior Plan Administrator failed to run the ADP test for the year under audit. The plan failed when he ran the ADP Test. Based on the following data, indicate what steps should be taken and what the tax implications would be.

<i>HCE</i>	<i>Compensation</i>	<i>Deferral</i>	<i>ADP</i>
Eric Davis	\$160,000	\$10,000	6.25%
Tiffany Clarke	\$160,000	\$10,000	6.25%
Jay Jacobi	\$160,000	\$10,000	6.25%
Emily Koplin	\$160,000	\$10,000	6.25%

**HCE ADP is 6.3%**

<i>NHCE</i>	<i>Compensation</i>	<i>Deferral</i>	<i>ADP</i>
Ross Tipping	\$45,500	\$1,000	2.2%
Carol Rodriguez	\$40,000	\$1,000	2.5%
Felica Valentine	\$35,100	\$900	2.6%
<b>Total</b>			<b>7.3%</b>

**NHCE ADP = 2.43 (7.3/3)**

**How much excess contributions are in the Plan?**

Since the maximum ADP for the HCEs is 4.43

(greater of 3.04 (1.25 \* 2.43) or

The lesser of 2+ (4.43) or 2x (4.86).

Thus, the “target” ADP is 4.43.

The excess contributions is calculated as follows:

Since each HCE has the same deferral percentage, under the leveling method, each percentage must be lowered from 6.25% to 4.43%. Thus, 1.82% x \$160,000 or \$2,912. must be returned to each individual. If each individual is lowered by \$2,912, the deferral percentage will be  $(\$10,000 - \$2,912) / \$160,000$  or 4.43%

Thus, \$2,912 must be returned to each HCE, and the excess contributions totaled .

Therefore, excess contributions for 1999 totaled \$11,648.

**What are the tax implications?**

First the ADP test must be run. Since the Plan failed the ADP test in 1999, the CODA portion of the plan is no longer qualified. Therefore employee deferrals are not permitted for 1999 as well as 2000. Assuming the excess

contributions are removed from the trust in 2001, employee deferrals may resume in 2001.

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***EXAMPLE 3: Illustrating leveling method***

There are three HCEs in a section 401(k) plan:

- HCE1 has compensation of \$80,000 and ECs of \$8,800 for an ADR of 11%;
- HCE2 has compensation of \$100,000 and ECs of \$9,000 for an ADR of 9%; and
- HCE3 has compensation of \$150,000 and ECs of \$10,500 for an ADR of 7%. The HCE ADP is 9%.

If the HCE ADP needs to be 8% to pass the ADP test, the amount of excess contributions is determined by multiplying one or more HCE's compensation by the percentage that such HCE's ADR would have to be reduced, using the percentage leveling method, in order to produce a HCE ADP of 8%.

The highest ADR percentage, HCE1's 11%, is reduced to the next highest, HCE2's 9%, and then both HCE1 and HCE2's reduced ADRs are further reduced to 8.5%, so that the HCE ADP using these reduced ADRs is 8%.

HCE1's ADR reduction by 2.5% produces excess contributions of \$2,000 (2.5% x \$80,000) and

HCE2's ADR reduction by 0.5% produces excess contributions of \$500 (0.5% x \$100,000) for a total amount of excess contributions of \$2,500.

For plan years beginning **before** January 1, 1997, corrective distributions of excess contributions (and excess aggregate contributions), adjusted for earnings, were made to the HCEs whose ADRs were used to determine the amount of excess contributions (or excess aggregate contributions) and in the same amount.

So in the example above, \$2,000 (adjusted for earnings) would be distributed to HCE1 and \$500 (adjusted for earnings) to HCE2.

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Section 1433(e) of SBJPA amended IRC section 401(k)(8)(C) and 401(m)(6)(C), effective for plan years beginning after December 31, 1996, to provide that corrective distributions are made based on HCEs' dollar amount of contributions rather than on their percentages.

In other words, excess contributions (and excess aggregate contributions) are distributed to HCEs who have the largest amount of contributions in the numerator of their ADR (or ACR) (a dollar leveling method).

The method of determining the amount of excess contributions (and excess aggregate contributions) remains the same. Thus the HCEs whose ADRs are used to calculate the excess amount may be different from the HCEs who receive a corrective distribution.

So in Example 5 above, the \$2,500 of excess contributions would be allocated \$1,900 to HCE3 (the HCE with the largest amount of ECs), \$400 to HCE2 (the HCE with the next largest amount of ECs) and \$200 to HCE1.

Note that if these distributions are made, the section 401(k) plan is treated as meeting the ADP test even though the HCE ADP, if recalculated after distributions, would not satisfy the ADP test.

A parallel method is used for the purpose of recharacterizing excess contributions under section 401(k)(8)(A)(ii).

**EXAMPLE 4-illustrating leveling method under SBJPA**

A plan has 3 HCEs and a fully vested matching contribution equal to the participant's deferrals that do not exceed 5% of compensation.

**Table I-Basic Data**

	Compensation	Deferrals	ADR	Match	ACR
HCE1	\$150,000	\$6,000	4%	\$6,000	4%
HCE2	\$120,000	\$6,000	5%	\$6,000	5%
HCE3	\$80,000	\$4,800	6%	\$4,000	5%

	ADP	ACP
HCE	5%	4.67%
NHCE	2.5%	2%

To correct ADP (HCE ADP cannot exceed 4.5%) by distributing excess contributions:

**STEP 1** - determine amount of excess and assign deemed ADRs to HCEs

To get HCE ADP to **4.5%**, reduce the ADR of HCE2 and HCE3 to 4.75%, which produces an excess of \$300 for HCE2 and \$1,000 for HCE3, for a total of \$1,300.

**STEP 2** - assign the excess to HCEs with largest deferrals

The \$1,300 is split evenly between HCE1 and HCE2 (because they have the same amount of deferrals), leaving them with \$5,350 each in deferrals:

	Remaining Deferrals	Deemed ADR
<b>HCE1</b>	\$5,350	4%
<b>HCE2</b>	\$5,350	4.75%
<b>HCE3</b>	\$4,800	4.75%

HCE deemed ADP = 4.5%

To correct ACP (HCE ACP cannot exceed 4%) by distributing excess aggregate contributions:

**STEP 3** - determine **amount of excess** and assign deemed ACRs to HCEs

To get HCE ACP to 4%, reduce the ACR of HCE2 and HCE3 to 4%, which produces an excess of \$1,200 for HCE2 and \$800 for HCE3, for a total of \$2,000.

**STEP 4** - assign the excess to HCEs with largest matches

The \$2,000 is split evenly between HCE1 and HCE2, leaving them with \$5,000 each in matching contributions:

	Remaining Matches	Deemed ACR
<b>HCE1</b>	\$5,000	4%
<b>HCE2</b>	\$5,000	4%
<b>HCE3</b>	\$4,000	4%

HCE deemed ACP = 4%

If the multiple use test fails (it does, since the sum of the HCE ADP and ACP exceeds the maximum permitted amount), go on to STEP 5. Correction under the plan is by distribution of excess aggregate contributions.

**STEP 5**-use deemed HCE ADP and ACP, determine maximum sum permitted and repeat STEPs 3 and 4.

Sum of HCE ADP and ACP is 8.5%; maximum permitted is 7.13% ((2 + 2%) + (1.25 x 2.5%)).

## Employee Plans CPE Topics For 2002

Need to reduce HCE ACP to 2.63% (by reducing all HCE ACRs to 2.63%) so that the sum of the HCE ADP (4.5%) and ACP equals 7.13%. This would produce an excess of \$2,055 for HCE1 (\$150,000 x 1.37%), \$1,644 for HCE2 (\$120,000 x 1.37%) and \$1,096 for HCE3 (\$80,000 x 1.37%), for a total of \$4,795. This would be assigned \$1,932 to be distributed from both HCE1 and HCE2 and \$932 from HCE3, leaving all three HCEs with matching contributions of \$3,068 each.

### RECHARACTERIZATION

Recharacterization occurs when the Plan allows an employee to recharacterize his excess contribution from an elective deferral to an employee after-tax contribution. The amount recharacterized must be included in income via Form 1099R.

The only time a plan may recharacterize excess contributions is during the first 2 ½ months following the end of the plan year being tested. The recharacterized amount is now considered in the ACP test as an EE Voluntary Contribution (the plan must permit employee Voluntary After Tax Contributions or Recharacterization is not an option).

### CONTRIBUTIONS

The plan may contribute QNECs and QMACs any time during the 12 months following the plan year-end without incurring the section 4979 tax. QNECs and QMACs are treated as elective contributions for purposes of the ADP test. However, these methods are not available if prior year data was used.

## EMPLOYER MATCHING CONTRIBUTIONS

### DEFINITION

Treasury Regulation ("I.T.Reg's") 1.401(m)-1(f)(12) defines the term Matching Contributions as:

- (A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;
- (B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral (as defined in I.T. Regs. 1.402(g)-1(b)); and (C) Any forfeitures allocated on the basis of employee contributions, matching contributions, or elective contributions.

## DOLLAR LIMIT ON EMPLOYEE DEFERRALS

Section 402(g) of the Code provides that an individual's elective for any taxable year shall be included in such individual's gross income to the extent the amount of such deferral for the taxable year exceeds \$7,000 (indexed for inflation). For 1999, the amount was \$10,000. For 2000 and 2001, the amount was \$10,500.

Section 401(a)(30) provides that in order for a plan to be qualified, it must provide that the amounts of elective deferrals under the Plan and all other Plans of an ER do not exceed the section 402(g) limit.

If the employee deferred more than the section 402(g) limit, the excess must be distributed by April 15<sup>th</sup> following the close of the plan year. A timely distribution of the excess is taxable to the participant in the year of deferral, but earnings are taxable in the year distributed. In addition, the excess distribution is taxed twice to the participant:

- The amount is taxed in the year of the excess arose, and
- The amount is again taxed in the year of distribution.

Thus, there is no "basis" created when the amount is taxed in the year the excess arose.

Note: Excess deferrals on behalf of the Highly Compensated Employees ("HCEs") distributed before April 15<sup>th</sup> **are** included in the ADP test but not counted as annual additions under section 415.

Excess deferrals on behalf of the Non-Highly Compensated Employees ("**NHCEs**") prohibited by section 401(a)(30) **are not** included in the ADP test and are not counted as annual additions.

If the excess is not distributed timely, the Plan's qualified status could be in jeopardy

### AUDIT HINTS

The auditor should verify that contributions were made in accordance with the written terms of the plan document. An employer may make matching contributions at the same time employee deferrals are made (on a pay period basis) or they may make the match at the end of the plan year.



If the pay period method is used, the Employer should perform a “true up” at plan year end.

Without such a step, some participants may not receive the full contribution they are entitled to, thereby jeopardizing the plan’s qualified status.

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**Example 1:**

In 1999, the Plan Document provides that the Employer will make a matching contribution equal to 100% of the Employee’s deferral up to 5% of pay. Furthermore, the Employer waits until the end of the year to calculate and contribute the match.

Joe Employee earned \$80,000 during 1999 and elected to defer 10% of pay or \$8,000. Thus, the Employer will make a match for Joe of \$4,000 (the lessor of \$8,000 (100% of deferral) or \$4,000 (5% of total compensation). Jane Employee earned \$160,000 during 1999 and also elected to defer 10% of pay. But because of section 402(g) she was only allowed to defer \$10,000. The Employer’s match for Jane was \$8,000 (the lessor of \$10,000 (100% of the deferral) or \$8,000 (5% of pay)).

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**Example 2**

Now consider what would happen if the ER was making the match on a pay period basis? Assume the ER has 26 pay periods during the year. Each pay period Joe would defer \$308 ( $\$80,000/26 = \$3077 * 10\%$ ) and the ER would match \$154 (the lessor of \$308 (100% of the deferral) or \$154 (5% of pay \$3077)).

At the end of the year Joe would have deferred \$8,000 ( $\$308 * 26$ ) and he would have received a matching contribution of \$4,000 ( $\$154 * 26$ ).

Under either method Joe’s deferral and matching contribution was the same. However, look what happens to Jane who is limited by section 402(g) during pay period 17. She is deferring \$615 per pay period ( $160,000/26 = \$6,154 * 10\%$ ) and receiving a matching contribution each pay period of \$308 (the lessor of \$615 (100% of the deferral) or \$308 (5% of pay \$6,154)).

Therefore, Jane’s deferral is \$10,000 and her match is \$5,000 ( $\$308 * 16 + \$1,600 * .05$ ). As illustrated above, she should have received a match of \$8,000.

Example 3:

The plan is a calendar year end plan. The year under audit is 2000. The Plan Document provides that Employer Matching Contributions will equal 100% of the amount deferred up to 10% of compensation. Jack earns \$140,000 and wishes to defer 15% of compensation. Jennifer earns \$200,000 and wishes to defer 7% of compensation. The employer calculates and pays the match on a pay period basis, there are 52 pay periods during the year. Answer the following questions.

1. During what pay period did Jack and Jennifer reach their section 402(g) limit?
2. How much had the employer contributed toward their matching contribution when they reached their section 402(g) limit
3. Based on your answer to #2, does the employer need to make additional matching contributions? If so, how much?

Answers:

1. PP 26 for Jack.  $1^{\text{st}} \$140,000/52 = \$2,692.31 * 15\% = \$403.85$ .  
 $2^{\text{nd}} 10,500/403.85 = 26$ .

- PP 49 for Jennifer.  $1^{\text{st}} \$160,000/52 = \$3,076.92 * 7\% = 215.38$   
 $2^{\text{nd}} \$10,500/215.38 = 48.75$

2. For Jack \$6,994.  $\$2,692.31 * 10\% = \$269$   
 $2^{\text{nd}} \$269 * 26 = \$6,994$   
(the match was limited to 10% of compensation earned during the first 26 pay periods)

3. For Jennifer \$10,500, calculated as follows:

$$1^{\text{st}} \$3,076.92 * 7\% = \$215.38$$
$$2^{\text{nd}} \$215.38 * 48.75 = \$10,500$$

(match is limited by the amount she deferred)

4. Yes, \$3,506 for Jack since the Plan Document states that the match will equal 100% of the amount deferred (\$10,500-\$6,994).  
No, for Jennifer since she received 100% of the amount deferred.