CHAPTER 5 Summary of Plan Requirements Under Notice 98-52 (ADP/ACP Safe Harbors), As Modified by Notice 2000-3

By Beth Levine (Gulf Coast)
And
Marty Licari and Steve Henry (Reviewers) (Great Lakes)
With
Al Reich (Reviewer)

INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

TABLE OF CONTENTS

SAFE HARBOR 401(K) AND (M) REQUIREMENTS ---- 3

WHY USE THE SAFE HARBOR NONDISCRIMINATION TEST ALTERNATIVES? ---- 3

GUIDANCE ---- 3

SMALL BUSINESS JOB PROTECTION ACT OF 1996 ---- 3
IRS NOTICE 98-52 ---- 4
IRS NOTICE 2000-3 ---- 5
THE LISTING OF REQUIRED MODIFICATIONS (LRM) ---- 6

WHEN A PLAN MUST BE AMENDED FOR SAFE HARBOR PROVISIONS ---- 6

DEFINITION OF COMPENSATION - SECTION IV.B ---- 7

THE ADP SAFE HARBOR ---- 9

MATCHING CONTRIBUTION REQUIREMENT ---- 9

NONELECTIVE CONTRIBUTION REQUIREMENT ---- 11

ADDITIONAL REQUIREMENTS AND FEATURES FOR SAFE HARBOR MATCHING AND NONELECTIVE CONTRIBUTIONS. ---- 11

PARTICIPANTS WHO ARE ELIGIBLE UNDER SAFE HARBOR PLANS ---- 11
VESTING REQUIREMENTS AND DISTRIBUTION REQUIREMENTS ---- 12
LIMITED RESTRICTIONS ON ELECTIVE CONTRIBUTIONS PERMITTED IN SAFE HARBOR PLANS ---- 13
PLAN AMENDMENT DURING THE YEAR TO SWITCH FROM SAFE HARBOR TO REGULAR ADP/ACP TEST --- 14

NOTICE REQUIREMENTS ---- 15

CONTENT REQUIREMENT ---- 16
CONTENT AND TIMING REQUIREMENT MODIFIED UNDER 2000-3 FOR PLANS ADOPTING THE SAFE HARBOR-NONELECTIVE CONTRIBUTION ---- 18
TIMING REQUIREMENT ---- 21

THE ACP SAFE HARBOR ----------22

SAFE HARBOR UNDER BASIC MATCHING FORMULA ---------- 22
SAFE HARBOR UNDER AN ENHANCED MATCHING FORMULA---------- 22
THE OTHER MATCHING CONTRIBUTIONS FORMULA ---------- 22

THE 401(K) SAFE HARBOR AND TOP HEAVY ----------25

TESTING METHODS AND SAFE HARBORS----------25

DESIGN-BASED SAFE HARBORS IN THE LRM AND OTHER WORKSHEETS ----------25

DEDUCTION SECTION 404 OF THE CODE ISSUE AND SAFE HARBORS----------28

Safe Harbor 401(k) and (m) Requirements

Objectives: At the end of this session:

1. You will be able to identify the alternative nondiscrimination testing methods or safe harbor 401(k) and (m) provisions and operations.

2. You will be able to identify required plan language and complete the determination checksheets 11 and 12 for the 401(k) and (m) design based safe harbor plans.

3. You will be able to perform various audit tests for 401(k) and (m) design based safe harbor plans.

Why Use the Safe Harbor Nondiscrimination Test Alternatives?

The pension community has lobbied for relief from nondiscrimination testing ADP/ACP tests under Internal Revenue Code sections 401(k) and (m). The main argument was for a cost-effective way to reduce administrative costs of the testing. Also, the sponsors were looking for a way to avoid refund distributions to the highly compensated employees, to correct for failure to meet the ADP and ACP tests.

After the flood of determination applications for GUST, we will see safe harbors as soon as we get back in the field.

> Audit hint: if you get a RICS return or Form 5500 with Code 2k in box 8a, then inquire as to whether the employer uses a safe harbor formula.

Guidance

SMALL BUSINESS JOB PROTECTION ACT OF 1996

The Small Business Job Protection Act of 1996, Pub. L. 104-188, added new sections 401(k)(12) and 401(m)(11) to the Code, effective for plan years beginning after December 31, 1998. These provisions added design-based safe harbor methods for satisfying the ADP test under section 401(k)(3)(A)(ii) and the ACP test under section 401(m)(2) of the Code.

A cash or deferred arrangement ("CODA") is treated as satisfying the ADP test if the CODA meets certain contribution and notice requirements.

A defined contribution plan is treated as satisfying the ACP test with respect to matching contributions if the plan meets:

- certain contribution and notice requirements contained in section 401(k)(12) and
- certain limitations on the amount and rate of matching contributions available under the plan.

IRS NOTICE 98-52

This notice provides guidance on the design based alternative or safe harbor methods in section 401(k)(12) and section 401(m)(11) of the Internal Revenue Code for satisfying the section 401(k) and section 401(m) nondiscrimination tests.

A CODA is treated as satisfying the ADP test under 401(k)(3)(A)(ii) of the Code if the arrangement satisfies

- the safe harbor contribution requirement and
- the notice requirement.

The safe harbor contribution requirement is satisfied for a plan year if the plan satisfies either:

- the matching contribution requirement or
- the nonelective contribution requirement.

The Safe Harbor contribution requirement must be satisfied without regard to section 401(l). The plan may satisfy the matching contribution requirement by providing for either the basic matching formula or an enhanced matching formula.

IRS NOTICE 2000-3

Notice 2000-3, 2000-1 C.B. 413 provides additional guidance regarding 401(k) plans that are intended to satisfy the 401(k) safe harbors. This notice makes it easier for employers to adopt and administer 401(k) safe harbors. Some of the changes made by this notice are:

- Encourages adoption of 401(k) safe harbor plans by giving sponsors of existing 401(k) plans the flexibility to wait as late as December 1 of a calendar year to decide to adopt the 401(k) safe harbor **3-percent employer nonelective** contribution method for that calendar year. **See Q&A 1 of 2000-3**

  The employer must give

  - notice (that satisfies the content requirement of V.C. of 98-52, as changed by Q&A 1, 7 and 8 2000-3) to eligible employees before the beginning of the plan year (satisfying the timing requirement of V.C.2 of 98-52 as modified by Q&A 9 of 2000-3, and

  - supplemental notice no later than 30 days before the end of the plan year.

  For further information, please see Q&A 1(2) of 2000-3.

- Permits 401(k) safe harbor plans to match elective or employee contributions on the basis of compensation for a payroll period, month, or quarter, see Q&A 2;

- Provides an extended period of time -- until May 1, 2000 -- for 401(k) plan sponsors adopting the 401(k) safe harbor methods for the first time in 2000 to provide the required safe harbor notice to employees (see Q&A 9);

- Permits plan sponsors to provide the 401(k) safe harbor notice electronically and otherwise simplifies the notice requirement (see Q&A 7);

- Permits plan sponsors using the 401(k) safe harbor matching contribution method to exit the safe harbor prospectively during a plan year (and switch to ADP and ACP nondiscrimination testing) if employees are notified beforehand (see Q&A 6)

- Makes clear how the 401(k) safe harbor rules apply in the case of a profit sharing plan to which a 401(k) feature is added for the first time during a plan year (see Q&A 11).

THE LISTING OF REQUIRED MODIFICATIONS (LRM)

The Listing of Required Modifications for CODAs provides guidance on suggested plan language for master or prototype plans. This document is a good reference for the required language.

WHEN A PLAN MUST BE AMENDED FOR SAFE HARBOR PROVISIONS

Section XI of Notice 98-52 provides that, generally, a plan sponsor that intends to use the safe harbor provisions for a plan year must adopt those provisions before the first day of that plan year.

> However, for the remedial amendment period, under Section 4 of Rev. Proc. 2000-27, 2000-26 I.R.B. 1272, a section 401(k) plan intending to take advantage of the safe harbor methods for the 1999, 2000 or 2001 plan year must generally be amended no later than the end of the 2001 plan year, retroactive to the first day of the 1999, 2000 or 20001 plan year, to reflect the first use of the safe harbor methods.

Pursuant to Q&A-1 of Notice 2000-3, a section 401(k) plan can be amended as late as 30 days prior to the end of a plan year to provide for the use of the safe harbor nonelective contribution method for that plan year, provided that a regular safe harbor notice (with modified content) is given to eligible employees before the beginning of the plan year and a supplemental notice is given no later than 30 days before the end of the plan year.

Pursuant to Q&A-11 of Notice 2000-3, a profit-sharing plan that does not contain a CODA generally can be amended as late as 3 months prior to the end of a plan year to provide for the use of the ADP/ACP safe harbor methods for that plan year.

Thus, in the case of a CODA that is added to an existing profit-sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during a plan year, the requirements of section V of Notice 98-52 will be treated as being satisfied for the entire plan year and the CODA will not be treated as failing to satisfy the requirements of section X of Notice 98-52, provided:

(1) the plan is not a successor plan (within the meaning of Notice 98-1),

(2) the CODA is made effective no later than 3 months prior to the end of the plan year, and

(3) the requirements of Notice 98-52 are otherwise satisfied for the entire period from the effective date of the CODA to the end of the plan year.

Thus, an existing calendar-year profit-sharing plan that does not contain a CODA may be amended as late as October 1 to add a CODA that uses a 401(k) safe harbor method for that plan year. A similar rule applies for purposes of section VI of Notice 98-52 in the case of the addition of matching contributions for the first time to an existing defined contribution plan at the same time as the adoption of the CODA.

Note however that the plan sponsor may not retroactively adopt a CODA. If the employer is adding a CODA (with the safe harbor for the first time), the CODA may not be retroactive. See Engineered Timbered Sales vs. Commissioner, 74 T.C. 808. A plan must be established within its initial year. There is no remedial amendment period until the plan is established.

Definition of compensation - section IV.B

Except as provided in section V.B.1.c.iii. of Notice 98-52, compensation means compensation as defined in section 1.401(k)-1(g)(2) of the regulations (which incorporates by reference the compensation definitions in sections 414(s) and 1.414(s)-1). Thus, a uniform definition of compensation satisfying section 1.414(s)-1 must be used for the ADP and ACP safe harbors for purposes of:

- the basic matching formula and the enhanced matching formula under section V.B.1.a.,
- the nonelective contribution requirement under section V.B.2., and
- the matching contribution limitations under section VI.B.

For example, a plan could use a definition of compensation that includes all compensation within the meaning of section 415(c)(3) and excludes all other compensation. (This is a section 414(s) safe harbor definition of compensation. See section 1.414(s)-1(c)(2).)

With respect to elective contributions under a plan using the ADP safe harbor matching formula, each eligible nonhighly compensated employee ("NHCE") may make elective contributions under a "reasonable definition" of compensation as defined under section 1.414(s)-1(d)(2). Such definition is not required to satisfy the nondiscrimination requirement of section 1.414(s)-1(d)(3).

> However, the plan must permit each eligible NHCE to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions under the plan for the plan year and the employee must be permitted to elect any lesser amount of elective contributions.

Compensation may not be limited to a specific dollar amount for NHCEs for purposes of the ADP and ACP safe harbors. (The last sentence in section 1.414(s)-1(d)(2)(iii) of the regulations does not apply.) Note that the annual compensation limit under section 401(a)(17) still applies.

A plan can limit an employee's compensation to the portion of the plan year in which the employee was an eligible employee under the plan, provided that this limit is applied uniformly to all eligible employees (see 1.401(k)-1(g)(2) of the Income Tax Regulations.

EXAMPLE 1: Illustrating compensation

An employer's section 401(k) plan defines compensation as "all salary, wages, bonuses, and other remuneration not exceeding $75,000." The plan does not satisfy the ADP/ACP test safe harbors because the definition of compensation excludes compensation over $75,000.

EXAMPLE 2: Illustrating compensation

An employer's section 401(k) plan allows employees to make elective contributions only from basic compensation, defined as salary, regular time wages, bonuses and commissions, and excluding overtime pay. This is a reasonable definition of compensation within the meaning of section 1.414(s)-1(d)(2) of the regulations, but is not necessarily nondiscriminatory.

The plan provides for a required matching contribution equal to 100 percent of each eligible employee's elective contributions, up to 4 percent of compensation. For purposes of the matching formula, compensation is defined as compensation under section 415(c)(3) of the Code. Under the plan, each NHCE who is an eligible employee is permitted to make elective contributions equal to at least 4 percent of the employee's compensation under section 415(c)(3) (that is the amount of elective contributions sufficient to receive the maximum amount of matching contributions available under the plan). This plan's definitions of compensation satisfy the safe harbor rules.

The ADP Safe Harbor

MATCHING CONTRIBUTION REQUIREMENT

As stated above, the employer has the option of meeting the ADP design safe harbor by choosing to satisfy either:

the Matching Contribution Requirement or

the Nonelective Contribution requirement.

The employer must also satisfy the notice requirement of Notice 98-52.

The Matching Contribution Requirement may be met by using either:

- the Basic Matching Formula, or
- the Enhanced Matching Formula.

1. The Basic Matching Formula is satisfied by providing matching contributions on behalf of each nonhighly compensated employee (NHCE) who is an eligible employee in an amount equal to

   (A) 100% of the employee's elective contributions that do not exceed 3 percent of the employee's compensation and

   (B) 50 percent of the amount of the employee's elective contribution that exceed 3 percent of the employee's compensation but do not exceed 5 percent of the employee's compensation.

2. The Enhanced Matching Formula provides matching contributions on behalf of each NHCE who is an eligible employee under a formula that, at any rate of elective contributions, provides

- an aggregate amount of matching contributions at least equal to the aggregate amount of matching contributions that would have been provided under the basic matching formula and

- the rate of matching contributions may not increase as an employee's rate of elective contributions increases.

These formulas are not satisfied if the rate of matching contributions that would apply with respect to any eligible highly compensated employee ("HCE") is greater than the rate of matching contributions that would apply with respect to any eligible NHCE who has the same rate of elective contributions.

EXAMPLE 3:

A plan provides that matching contributions will be made at the following rates:

100 percent of an employee's elective contributions that do not exceed 2 percent of compensation and

75 percent of the employee's elective contributions that exceed 2 percent but do not exceed 5 percent of compensation.

This formula **does not** satisfy the enhanced matching formula since the aggregate amount that is provided by this formula is not at least equal to the amount that would have been provided under the basic matching formula at all rates of elective contributions.

Under the basic matching formula, matching contributions of 100 percent would be made on the amount of the employee's elective contributions that do not exceed 3 percent of compensation.

Under the plan's formula, the amount of matching contributions at 3 percent is less than 100 percent. For additional examples, see the examples in section V.B.3. of Notice 98-52.

OTHER REQUIREMENTS FOR MATCHING CONTRIBUTIONS

(i) **Matching rate cannot be higher for highly compensated employees ("HCEs") -** Under section V.B.1.b. of Notice 98-52, a matching formula does not satisfy the safe harbor if, at any rate of elective contributions, the rate of matching contributions for an eligible HCE is greater than the rate of matching contributions for an eligible NHCE at the same rate of elective contributions.

EXAMPLE 4:

A plan covers Divisions A and B, both of which have NHCEs and HCEs. If the plan provides for a basic matching formula for Division A and an enhanced matching formula for Division B, (such as 100 percent match of each employee's elective contributions up to 4 percent of a Division B employee's section 415(c)(3) compensation),

the rate of match for a **Division B HCE** at a rate of elective contributions of 4 percent is greater than the rate of match **for a Division A NHCE** at the same rate of elective contributions; therefore, the plan would not satisfy the ADP test safe harbor (see example 5 under section V.B.3 of Notice 98-52).

Nonelective Contribution Requirement

The employer may elect to use the nonelective contribution requirement as an alternative to the matching contribution requirement. The nonelective contribution requirement is satisfied if, under the terms of the plan, the employer is required to make a safe harbor nonelective contribution on behalf of each eligible nonhighly compensated employee in an amount equal to at least 3% of the employee's compensation. See section V. B. 2 of Notice 98-52, 1998-2 C.B. 634. .

Additional Requirements and features for Safe Harbor Matching and Nonelective Contributions.

PARTICIPANTS WHO ARE ELIGIBLE UNDER SAFE HARBOR PLANS

Under Notice 2000-3, Q&A-10, the plan that uses one of the 401(k) safe harbor methods is not required to provide safe harbor matching or nonelective contributions to participants who have not attained age 21 and performed one year of service.

There are special rules with respect to a plan that benefits employees that are under age 21 and have less than one year of service (the age and service requirements under section 410(a)). Under section 410(b)(4)(B) of the Code, an employer can apply the coverage rules separately to the portion of the plan that benefits only employees who benefit under the plan but who would not meet the age and service requirements under section 410.

> For 401(k) purposes, the plan may be treated as two separate plans and the ADP safe harbor test **need only be satisfied by one of the plans**, as long as the employees not meeting the age and service requirements are also disaggregated for section 410(b) of the Code for coverage.

The safe harbor contributions may not be limited to those employees who are:

> Still employed on the last day of the plan year or
>
> Worked more than a minimum number of hours during the plan year.

Contrast this requirement under Notice 98-52 with the requirements for a nonsafe harbor profit sharing plan (with or without a 401(k) feature), where the employer may exclude an employee who has worked less than 1,000 hours and is not employed on the last day of the plan year.

The employer may exclude Highly Compensated Employees ("HCE")] from receiving the safe harbor matching and nonelective contributions.

VESTING REQUIREMENTS AND DISTRIBUTION REQUIREMENTS

The plan language must specify full vesting of the safe harbor matching and nonelective contributions. See section 401(k)(12)(E) of the Code.

Compare this requirement with vesting for section 401(k) and (m) without the safe harbor contributions.

> The usual vesting requirement would be no more than either 100% vesting after 5 years of service or three to seven year graded vesting under section 411(a)(2) of the Code.

Note that beginning in 2002, under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), employer matching contributions are to be either:

- Fully vested or
- 2-6 graded vesting.

The plan must also specify that the safe harbor matching and safe harbor nonelective contributions are subject to the in-service withdrawal restrictions of section 401(k)(2)(B) of the Code and section 1.401(k)-1(d) of the Income Tax Regulations.

The contributions and earnings must not be distributed earlier than:

- separation from service,
- death,
- disability,
- an event described in section 401(k)(10) of the Code or
- age 59 ½ for a profit sharing or stock bonus plan.

The safe harbor contributions may not be used for hardship distributions, but are available for loans, providing that the plan document permits loans.

Note that under EGTRRA, the term "separation from service" is replaced with "severance from employment". This change of terms effectively repeals the same desk rule, which prevented a separation from service (and thus preventing a distributable event from occurring) if the employee performs the same functions for a successor employer.

LIMITED RESTRICTIONS ON ELECTIVE CONTRIBUTIONS PERMITTED IN SAFE HARBOR PLANS

Generally, the matching contribution requirement in Notice 98-52 is not satisfied if elective contributions by nonhighly compensated employees are restricted. However, plan sponsors are permitted to make specific restrictions on elective contributions, as follows:

a) the sponsor may impose reasonable limits upon the periods during which the employees can make or change deferral elections;

b) the sponsor may limit the amount of the elective contributions that may be made to whole percentages of pay or whole dollar amounts;

c) the sponsor may limit the type of compensation that may be deferred; and

d) the sponsor may provide for the limits on elective contributions under section 402(g) or 415 of the Code

e) the sponsor may limit the amount of elective contributions due to hardship distributions or withdrawals of employer contributions.

See section 401(k)(2)(B) of the Code and section 1.401(k)-1(d)(2) of the I. T. Regs. for the requirements for hardship distributions under a CODA.

Note that EGTRRA has changed the hardship rules. [Hardship is defined as immediate and heavy financial need of the employee where such employee does not have other available resources to meet this need. Hardship distributions are usually subject to spousal consent requirements of sections 401(a)(11) and 417 of the Code.

There is a "safe harbor method" for determining if a hardship exists. A plan that uses the safe harbor determination must suspend future deferrals of the participant taking the distribution for a 12 month period following the date of the hardship withdrawal. Under EGTRRA, the IRS is directed to change their regulation from a 12 month suspension period to a 6 month suspension period.

PLAN AMENDMENT DURING THE YEAR TO SWITCH FROM SAFE HARBOR TO REGULAR ADP/ACP TEST

Under Notice 2000-3, Q&A 6, a plan can be amended during the plan year to reduce or eliminate matching contributions provided:

(1) A supplemental notice is given to all eligible employees explaining the consequences of the amendment and informing them of the effective date of the reduction or elimination of matching contributions and that they have a reasonable opportunity (including a reasonable period) to change their cash or deferred elections and, if applicable, their employee contribution elections;

(2) The reduction or elimination of matching contributions is effective no earlier than the later of

(i) 30 days after eligible employees are given the supplemental notice and

(ii) the date the amendment is adopted;

(3) Eligible employees are given a reasonable opportunity (including a reasonable period) prior to the reduction or elimination of matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(4) **The plan is amended to provide that the ADP test and, if applicable, the ACP test will be performed and satisfied for the entire plan year using the current year testing method**; and

(5) All other safe harbor requirements are satisfied through the effective date of the amendment.

Notice Requirements

A safe harbor plan requires timely notice to the employee of the employee's rights and obligations under the plan. The notice must be written and meet both content and timing requirements. See IRC section 401(k)(12)(D) and 401(m)(11)(A) for the written notice requirement. The content requirement requires that the notice must describe the safe harbor method in use, making elections and other plans involved.

The notice requirement is satisfied if:

1. each eligible employee for the plan year is given written notice of the employee's rights and obligations under the plan and

2. the notice satisfies

- the content requirement of section V.C.1. of Notice 98-52 and

- the timing requirement of section V.C.2. of Notice 98-52, both sections as modified by Notice 2000-3.

CONTENT REQUIREMENT

The content requirement requires that the notice must describe the safe harbor method in use, making elections, any other plans involved, etc. (with 1999 transition relief).

GENERAL RULE

The content requirement of section V.C.1 of 98-52 is satisfied if the notice:

(1) is sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan and

(2) is written in a manner calculated to be understood by the average employee eligible to participate in the plan.

A notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes:

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

(ii) any other contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;

(iii) the plan to which safe harbor contributions will be made (if different than the plan containing the CODA);

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

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

(vi) the periods available under the plan for making cash or deferred elections; and

(vii) withdrawal and vesting provisions applicable to contributions under the plan.

1999 TRANSITION RELIEF FOR CONTENT REQUIREMENT

For a plan adopting the safe harbor provisions for a plan year that begins **before January 1, 2000**, a notice will not fail to satisfy the content requirement for that plan year merely because the notice does not include all of the items listed in paragraph 1.a of this section V.C (see items above), provided that the notice satisfies a reasonable good faith interpretation of the notice requirements under § 401(k)(12) and 401(m)(11).

A SAFE HARBOR NOTICE CAN CROSS-REFERENCE THE PLAN'S SPD FOR A PORTION OF THE INFORMATION REQUIRED IN THE NOTICE UNDER Q&A 8, 2000-3

Under Q&A 8, plan will not fail to satisfy the content requirement merely because, in the case of the information described in items

(ii) (relating to any other contributions under the plan),

(iii) (relating to the plan to which safe harbor contributions will be made),

(iv) (relating to the type and amount of compensation that may be deferred), and

(vi) (relating to withdrawal and vesting provisions) of paragraph 1.a.,

the notice instead cross-references the relevant portions of an up-to-date summary plan description that has been provided (or concurrently is provided) to the employee.

However, the notice contribution formula used under the plan (including a description of the levels of matching **must still accurately describe**:

(1) the safe harbor matching or nonelective contributions, if any, available under the plan) and state that these contributions (as well as elective contributions) are fully vested when made and

(2) how to make cash or deferred elections (including any administrative requirements that apply to such elections) and the periods available under the plan for making such elections.

In addition, the notice must also provide information that makes it easy for eligible employees to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of the individuals or offices from whom employees can obtain such plan information.

PROVIDING NOTICE USING ELECTRONIC MEDIUM, Q&A 7

See Q&A -7 and of Notice 2000-3 provides that the content requirement can be satisfied using electronic media and referencing the plan's summary plan description. Under Q&A 7, a plan will not fail to satisfy the notice requirement of section V.C. of Notice 98-52 (as modified by this notice) with respect to an employee merely because, instead of receiving the notice on a written paper document, the employee receives the notice through an electronic medium reasonably accessible to the employee, provided that

- the system under which the electronic notice is provided is reasonably designed to provide the notice in a manner no less understandable to the employee than a written paper document and

- under such system, at the time the notice is provided, the employee is advised that the employee may request and receive the notice on a written paper document at no charge, and, upon request, that document is provided to the employee at no charge.

CONTENT AND TIMING REQUIREMENT MODIFIED UNDER 2000-3 FOR PLANS ADOPTING THE SAFE HARBOR-NONELECTIVE CONTRIBUTION

INTRODUCTION

Generally, a plan that is intended to satisfy the 401(k) safe harbor requirements for a plan year must, **prior to the beginning of the plan year**, contain language to that effect and must specify the 401(k) safe harbor method that will be used. (However, see section XI.B. of Notice 98-52 and Rev. Proc. 99-23, 1999-16 I.R.B. 5, for the remedial amendment period applicable to plan changes incorporating the 401(k) safe harbor provisions.)

Under Q&A-1 of Notice 2000-3, the content requirement is modified for a section 401(k) plan that wants to **reserve the option** of using the safe harbor nonelective contribution method to satisfy the ADP/ACP test for a plan year.

Under Q&As -1 and -6 of Notice 2000-3, a supplemental notice (with special content requirements) may have to be given during the plan year.

Thus, notwithstanding section XI.A. of Notice 98-52 (which generally requires a plan sponsor to adopt the safe harbor provisions before the first day of the plan year), a plan that provides that it will satisfy the current year ADP (and, if applicable, ACP) testing method for a plan year **may be amended not later than 30 days before the last day of the plan year** to specify that the 401(k) safe harbor nonelective contribution method will be used for the plan year (including that the safe harbor nonelective contribution will be made), provided that the plan otherwise satisfies the ADP (and, if applicable, ACP) test safe harbor for the plan year (including the notice requirement under section V.C. of Notice 98-52, as modified by this notice).

MODIFIED NOTICE MUST BE GIVEN BEFORE THE BEGINNING OF THE PLAN YEAR

To take advantage of this exception, notice must still be given to the employees in accordance with the content requirement of section V.C.1 before the beginning of the plan year. However, instead of stating the amount of the safe harbor nonelective contribution to be made under the plan, the notice given to eligible employees before the beginning of the plan year must provide that:

(a) the plan **may be amended during the plan year to provide that the employer will make a safe harbor nonelective contribution of at least 3 percent** to the plan for the plan year, and

(b) if the plan is so amended, **a supplemental notice will be given to eligible employees 30 days prior to the last day** of the plan year informing them of such an amendment, and

SUPPLEMENTAL NOTICE MUST BE GIVEN 30 DAYS PRIOR TO THE END OF THE PLAN YEAR

In addition to the above notice, a supplemental notice must be provided to all eligible employees no later than 30 days prior to the last day of the plan year stating that a 3 percent safe harbor nonelective contribution will be made for the plan year. For administrative convenience, the supplemental notice may be provided separately or as part of the safe harbor notice for the following plan year.

Similar rules apply if, pursuant to section IX.A.1. of Notice 98-52, the safe harbor nonelective contribution is made to another plan of the employer.

Thus, for example, a plan sponsor that

> maintains a calendar-year 401(k) plan using the current year ADP testing method, and
>
> wishes to have the flexibility to decide toward the end of a plan year whether or not to adopt the 401(k) safe harbor nonelective contribution method with respect to its 401(k) plan

could achieve that flexibility by providing the initial notice described in section V.C. of Notice 98-52- as modified by the changes in 200-3 with respect to the changes:

- described above (Q&A-1)
- with respect to electronic media (Q&A-7), and
- with respect cross referencing the SPD (Q&A-8) of this notice (the notice changes described above) before the beginning of the plan year, as provided under section V.C.2. of Notice 98-52 (as modified by Q&A-9 of this notice).

This notice must be provided before the beginning of the plan year (modified by the exception in Q&A 9 of 2000-3 which allows notice to be provided by May 1, 2000 if the plan is adopting the safe harbor for the first time).

If the plan sponsor then decides to adopt the 401(k) safe harbor nonelective contribution method for the plan year, the plan sponsor must, by December 1 of the plan year,

i. amend the 401(k) plan accordingly and

ii. provide a supplemental notice to all eligible employees stating that a 3-percent safe harbor nonelective contribution will be made for the plan year.

A plan sponsor that takes advantage of the flexibility provided under this Q&A-1 is not required to continue using the 401(k) safe harbor nonelective contribution method for the following plan year and is not limited in the number of years that it takes advantage of this flexibility**.**

Audit hint: review the plan's "Notice to Participants" to make sure that it is issued annually, by the required 30 days prior to any plan year, in which the safe harbor is effective.

TIMING REQUIREMENT

The timing requirement requires that the plan sponsor must provide notice within a reasonable period.

This requirement is deemed to be satisfied if the notice is given to each eligible employee at least 30 days and not more than 90 days before the beginning of each plan year (with special rules for employees who become eligible after such 90th day). Thus, the safe harbor notification must be made annually. Transition relief for 1999 and 2000 is provided.

1999 TRANSITION RELIEF FOR TIMING REQUIREMENT UNDER V.C.2.C OF 98-52

For a plan year that begins on or before April 1, 1999, the notice described in this section V.C satisfies the timing requirement for that plan year (with respect to an existing section 401(k) plan or a newly established one) if the notice is given on or before March 1, 1999.

However, in order to satisfy the ADP or ACP test safe harbor for the plan year, a plan that is using the transition relief provided under this section V.C.2.c still must satisfy the otherwise applicable requirements of this Notice 98-52 with respect to the entire plan year.

TRANSITION RULE FOR A PLAN THAT ADOPTS A 401K SAFE HARBOR FOR THE FIRST TIME IN THE YEAR 2000—Q&A 9, 2000-3

Notice 2000-3 provides an extended period of time-until May 1, 2000-for 401(k) plan sponsors adopting the 401(k) safe harbor methods for the first time in 2000 to provide the required safe harbor notice to employees.

Thus, in the case of a plan sponsor that adopts a 401(k) safe harbor method for the first time with respect to a plan for a plan year that begins on or after January 1, 2000 and on or before June 1, 2000, the notice described in section V.C. of Notice 98-52 satisfies the timing requirement for that plan year if the notice is given on or before May 1, 2000.

This transition relief applies whether the 401(k) safe harbor method is adopted under a newly established 401(k) plan or under a preexisting 401(k) plan.

In order to satisfy the 401(k) safe harbor requirements for the plan year, however, a plan that uses the transition relief provided under this Q&A-9 still must satisfy the otherwise applicable requirements of Notice 98-52 (as modified by this notice) with respect to the entire plan year.

Thus, for example, in the case of a 401(k) plan that uses the 401(k) safe harbor matching contribution method, matching contributions still must be made with respect to elective contributions made prior to the date the safe harbor notice is provided to employees in the same amount as if the 401(k) safe harbor matching contribution method had been in place since the beginning of the plan year.

The ACP Safe Harbor

Under section VI of Notice 98-52, a plan satisfies the ACP safe harbor if:

A) each nonhighly compensated employee eligible to receive a matching contribution is also an eligible employee under a CODA that satisfies the ADP test safe harbor under section V of Notice 98-52 and

B) The plan satisfies the matching contribution limitations under section VI.B of Notice 98-52.

There are three ways to satisfy the matching contribution limitations.

SAFE HARBOR UNDER BASIC MATCHING FORMULA

Section VI (B)(1) of 98-52 provides that a plan satisfies the ACP test if the plan satisfies the ADP test safe harbor using the basic matching formula of section V. B. 1 of Notice 98-52 and no other matching contributions are provided under the plan;

SAFE HARBOR UNDER AN ENHANCED MATCHING FORMULA

Section VI (B)(2) of 98-52 provides that a plan satisfies the ACP test if the plan satisfies the ADP test safe harbor using an enhanced matching formula under which matching contributions are only made with respect to elective contributions which do not exceed 6% of an employee's compensation and no other matching contributions are made under the plan; or

THE OTHER MATCHING CONTRIBUTIONS FORMULA

Section VI(B)(3) provides that the matching limitations satisfy the ACP test safe harbor, if under the plan:

1. the matching contributions are not made with respect to elective contributions or employee contributions that in the aggregate exceed 6% of the employee's compensation,

2. the rate of the matching contributions does not increase as the rate of employee or elective contributions increases and

3. the rate of the matching contributions for a highly compensated employee does not exceed the rate for any nonhighly compensated employee.

In addition, the elective contributions or employee contributions that are used to determine the matching contributions may be restricted only as permitted in section V. B. 1. c. of Notice 98-52.

A plan that provides for discretionary matches, in addition to nondiscretionary matches needed to satisfy the ADP test safe harbor, can satisfy the ACP test safe harbor if the discretionary matches in the aggregate do not exceed a dollar amount equal to 4% of the employee's compensation.

This limitation on matching contributions made at the employer's discretion does not apply to plan years beginning before January 1, 2000.

On audit or determination assignments, look out for plans that apply the wrong date to this provision.

EXAMPLE 13: **Illustrating ADP test and ACP test safe harbor provisions**

Beginning in January 1, 2000, an employer maintains a plan which contains a CODA that satisfies the ADP test safe harbor using a 3 percent safe harbor nonelective contribution.

The plan also provides matching contributions equal to 50 percent of each eligible employee's elective contributions that do not exceed 6 percent of compensation.

Finally, the plan provides for a discretionary match equal to 50 percent of each eligible employee's elective contributions that do not exceed 6 percent of compensation.

Elective contributions are limited to 10 percent of compensation (which satisfies section 414(s)) and are limited in accordance with sections 402(g) and 415. Employees may change their deferral elections at any time. Matching contributions are fully vested after 3 years of service. The plan is maintained on a calendar-year basis and all contributions for a plan year are made within 12 months after the end of the plan year.

The plan satisfies the ADP test safe harbor with the 3-percent nonelective contribution provision. The plan also satisfies the matching contribution limitations of section VI.B.3. since:

1. the matching contributions are not based on elective contributions that exceed 6 percent of the employee's compensation,

2. the rate of matching contributions does not increase as the rate of elective contributions increases, and

3. the rate of matching contributions for any eligible HCE does not exceed the rate of matching contributions for any eligible NHCE at the same rate of elective contributions.

Finally, the plan does not fail to satisfy the ACP test safe harbor on account of discretionary matching contributions because, under the plan, the dollar amount of discretionary matching contributions cannot exceed 4 percent of an employee's compensation.

EXAMPLE 14: Illustrating "in the aggregate exceed 6 percent of compensation"

The facts are the same as in the previous example, except that the plan **also** provides matching contributions equal to 50 percent of each eligible employee's after-tax employee contributions that do not exceed 6 percent of compensation.

The plan does not satisfy the limitations of section VI.B. because matching contributions can be made with respect to elective contributions and employee contributions that, in the aggregate, equal 12 percent of compensation (and thus exceed 6 percent of compensation).

This differs from the discretionary match requirement which limits the discretionary matches to a dollar amount.

The 401(k) Safe Harbor and Top Heavy

Under Notice 98-52, the safe harbor nonelective contributions may be counted toward the section 416 minimum contribution requirement for top heavy plans. If a plan allocates to all eligible employees a 3% safe harbor nonelective contribution, the plan would generally satisfy the top heavy minimum contribution requirement under section 1.416-1 M-18 of the I. T. Regs. Compare this treatment to CODAs where the elective deferral and matching contributions may not be used for purposes of satisfying the minimum top-heavy contribution requirement. Also, compare this treatment to SIMPLE 401(k) plans where the plan is deemed not top heavy.

Testing Methods and Safe Harbors

Under Notice 98-52 and for purposes of Notice 98-1, a plan that uses the safe harbor methods to satisfy the ADP or ACP test for a plan year is treated as using the current year testing method for that plan year. The plan is therefore subject to the rules contained in section VII of Notice 98-1 relating to changes from the current year to prior year testing. In addition, in the case of a plan that is not maintained on a calendar year basis, the anti-abuse provision of section VIII of Notice 98-1 applies in a similar manner to changes between the safe harbor methods and the current or prior year testing method.

DESIGN-BASED SAFE HARBORS IN THE LRM AND OTHER WORKSHEETS

Refer to the LRM for sample plan language regarding the safe harbor requirements. LRM section XX is required only in a plan offering the design-based safe harbor methods for satisfying the ADP test or the ADP and ACP tests (a safe harbor CODA).

A plan that satisfies the ADP/ACP safe harbors must also satisfy all other applicable requirements of the Code, including

A. the other requirements of section 401(k) of the Code,

B. the nondiscriminatory availability of benefits, rights and features under section 401(a)(4) of the Code and

C. the limitations of sections 401(a)(17), 401(a)(30) and 415 of the Code.

A plan providing for employee contributions or matching contributions that fail to satisfy the ACP safe harbor test, must satisfy the regular ACP test under section 401(m)(2) of the Code. See Notices 98-52 and 2000-3.

If only safe harbor contributions may be made under the plan, then the LRM sections VI, VII, VIII, IX, X, XI XII, XIII XIV, XV and XIX may be omitted. These LRM sections provide the language required for the Actual Deferral Percentage test under sections 401(a)(4) and 401(k)(3) of the Code and Notices 98-1 and 97-2, the distribution of excess contributions under 401(k)(8) and 4979, recharacterization under 401(k)(8), matching contributions under 401(m), forfeitures and vesting of matching contributions under 411(a)(2), qualified matching contributions under 401(m), limitations on employee and matching and matching contributions under 401(m) and 401(a)(4), Notices 97-2 and 98-1, distribution of excess aggregate contributions under section 401(m)(6) and 4979, qualified nonelective contributions under 1.401(k)-1(b)(5)(i), nonforfeitability and vesting under 401(k)(2)(C), 401(m)(4)(c)(ii) and 411(a)(3) and finally 401(k) SIMPLE language under 401(k)(11) and 401(m)(10) and Rev. Proc. 97-9.

A Safe Harbor CODA must satisfy the requirements of CODA LRM I, II (first sentence only), III, IV, V, XIV (only for Elective Deferrals and only for the enumerated distributable events permitted under the plan), XVII (if the plan permits hardship distributions of Elective Deferrals) and XIII. These LRM sections provide the language required for the adoption statement; participation and coverage under IRC section 401(k)(2)(D) and 401(k)(4); elective deferrals under section 401(k); elective deferral contribution limits under IRC section 402(g) and 401(a)(30); distribution of excess elective deferrals under IRC section 402(g); qualified nonelective contributions under I. T. Reg. Section 1.401(k)-1(b)(5)(i); hardship distributions under IRC section 401(k)(2)(B), I. T. Reg.s section 1.4019k)-1(d)(2), and Rev. Proc. 2000-20, 2000-6 I. R. B. 553 and top heavy under IRC section 416.

However, if a plan sponsor provides for an option whereby the plan can be amended by the employer during a plan year to become a safe harbor CODA plan, for that plan year, then the plan must also contain all the CODA LRMs appropriate for a CODA that is not using the safe harbor methods, as well as the LRM XX for the safe harbor methods. If plan provides an option whereby a safe harbor CODA using safe harbor matching contributions can be amended by the employer during a plan year to prospectively eliminate the safe harbor matching contributions and become a regular CODA using the current year ADP/ACP test methods for the entire plan year, then the plan must contain the CODA LRMs

appropriate for a CODA that is not using the safe harbor methods, as well as the LRM XX for the safe harbor method.

See also the determination worksheets 11 Employee Benefit Plan Employee and Matching Contributions and 12 Section 401 (k) Requirements for required language and guidance on CODA and matching requirements, including language required for the safe harbor methods.

You may obtain the worksheets 11 and 12, with the explanations and deficiency paragraphs from the Intranet forms depository, on the IRSWEB Homepage.

Worksheet 11 is Form 8799 Rev. 4-2000. Worksheet 12 is Form 9002. The Explanation for Worksheet 11 is Document 7334 Rev. 4-2000. The Explanation for Worksheet 12 is Document 7335 Rev. 4-2000. The Deficiency Paragraphs for Worksheet 11 is Form 9416 Rev. 12-98. This form has not yet been updated for changes to the Code for current law. The Deficiency Paragraphs for Worksheet 12 is Form 9417 Rev. 12-98. This form has not yet been updated for changes to the Code for current law. However, EDS paragraphs for the Worksheets 11 and 12 have been updated on the system. These deficiency paragraphs are numbers 1152 through 1159 for Worksheet 11 and 1287 through 1299 for Worksheet 12.

Determinations Users Hint: the directions for Worksheet 11 section VII Safe Harbor CODA refers the user to always complete Worksheet 12 and refer to the Explanation #12 to ensure that the plan meets all applicable requirements. The directions for Worksheet 12 direct the user to see the Explanation for Worksheet 11 to determine whether Worksheet 11 or a portion of it must also be completed. See also Notice 98-52, 1998-46 I.R.B.16 and Notice 2000-3, 2000-4 I.R.B. 413 for the ADP and ACP test safe harbor requirements in greater detail.

Note that restrictions on multiple use under section 1.401(m)-2 of the I. T. Regs. do not apply to a CODA that satisfies the ADP safe harbor. In addition, the restrictions on multiple use under section 1.401(m)-2 do not apply to a defined contribution plan that satisfies the ACP test safe harbor, if the plan does not permit employee contributions. See section VIII of Notice 98-52 for details.

Deduction Section 404 of the Code Issue and Safe Harbors

In general, the defined contribution limit under section 404 is 15% of eligible compensation. The definition of compensation for this purpose excludes the deferrals.

The 15% limit applies to all contributions to a profit sharing plan, including the deferrals, match and profit sharing (discretionary) portions.

See Publication 560 for the explanation of the 10% excise tax on nondeductible contributions made to qualified pension, profit sharing, stock bonus or annuity plans and to SEPs.

EXAMPLE 1

Suppose eligible gross payroll for 1999 is $400,000, deferrals made are $50,000 and the 15% deduction limit is therefore $60,000 (($400,000 x 15%). The safe harbor 3% non-elective contribution is $13,500 (3% x $450,000). (Note, you don't reduce income by the amount of elective deferrals). The total of $13,500 non-elective contribution and $50,000 is $63,500. The deductible amount is only $60,000. The $3,500 excess is a nondeductible contribution, subject to the excise tax under section 4972 of the Code for Tax on Nondeductible Contributions to Qualified Employer Plans. However, note the exception under section 4972(c)(6) (another plan). Also, note the changes to EGTRRA.

If you detect this issue upon audit, solicit and secure the Form 5330 for the excise tax and solicit and secure payment of the tax due.

The agent should consider assessing failure to file and failure to pay penalties, if the Form 5330 is delinquent.

Another issue to consider is the disallowance of the deduction of $3,500 either on Form 1120, for Corporate Income Tax; Form 1065, for Partnership Income or Form 1040, for Individual Income Tax, (Schedule C employer-taxpayer). The revenue agent may use the discrepancy adjustment program for the adjustments to Form 1120 or Form 1040.

Currently, the Form 1065 or 1120S for Subchapter S Corporations may not be processed through TE/GE EP Discrepancy Adjustments. The revenue agent should consider making a referral to LMSB, SB/SE or W & I (as appropriate for these taxpayers) or the revenue agent should try to solicit amended returns from the employer for the disallowed deduction.

Your workpapers should document which method was used to address the disallowance issue. You will need the manager to approve either the referral or the Discrepancy Adjustment. Refer to the Internal Revenue Manual for specific procedures for Discrepancy Adjustments and Referrals.