Chapter 6

401k Examination Techniques Using Automated Workpapers

By 401(k) compliance group members
With
Carla Smith (Great Lakes), Lori Brozek (MidAtlantic) and Margie Waldman (Gulf Coast),
And
Jerry Livingston (Special Review), Burt Katz (Northeast) and Al Reich, Reviewers

INTERNAL REVENUE SERVICE
TAX EXEMPT AND GOVERNMENT ENTITIES

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Background of workpapers and overview of chapter

Introduction

In an effort to assist EP Agents with IRC 401(k) examinations, automated workpapers were developed. The workpapers are intended to provide the EP Agent with tools that assist the Agent during the examination. The automated workpapers include links to the IRC 401(k) Examination Guidelines, the Code, Regulations, and other technical reference material.

This chapter will provide a brief overview of the automated workpapers and the technical reference material and will reference the question numbers for the workpapers.

This chapter will present the material by providing the audit steps that is listed in the automated workpapers and then provide a brief overview of the technical issues and audit techniques that pertain to those audit steps.

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Background of workpapers and overview of chapter, Continued

Objectives

At the end of this lesson you will be able to:

1. Determine whether an employer and plan is eligible to maintain a CODA.
   (G01)

2. Determine whether the form of the plan contains the proper provisions that are applicable to IRC 401(k) plans. (G02)
   - Definition of Compensation
   - Eligibility
   - Vesting
   - Top Heavy Minimums
   - Distributions

3. Review the examination steps necessary to ensure that the plan complied in operation with:
   - Eligibility Requirements (G03)
   - Vesting Requirements (G04)
   - Effective Date of CODA (G05)
   - Definition of Highly Compensated Employee (HCE) (G06)

4. Determine if the plan was a Safe Harbor or SIMPLE Plan and whether the plan was qualified in form and operation. (G07, G08)

5. Determine whether the CODA satisfied coverage. (G09)

6. Determine whether the ADP test was performed properly. (G10, G11)
   - Determine whether the plan used current or prior year testing.
   - Determine whether a change in method from current to prior year testing was permitted.
   - Determine whether ADP correction was made properly.

7. Determine whether certain plan limits were met, including:
   - IRC 402(g) (G12)
   - IRC 415 (G13)
   - IRC 416 Top Heavy minimum contribution (G14)

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Background of workpapers and overview of chapter, Continued

Objectives
(continued)

8. Determine whether a CODA that is part of a Cafeteria Plan is qualified. (G15)

9. Determine whether deferrals were deposited timely. (G16)

10. Determine whether distributions, including hardship distributions, were made in accordance with the terms of the plan. (G17, G18)

11. Determine whether any Contingent Benefits affect the CODA. (G19)

Determine whether the elective deferrals are made during the employer's taxable year. (G20)

Eligible employer and eligible plan-GO1

Audit step-GO1

Verify that the employer is eligible to maintain a CODA, if not, the CODA is nonqualified. Verify that the plan is eligible to contain a CODA feature. If not, the plan is not qualified. Skip to G21.

Exam guidelines defines eligible employers

The examination guidelines provide an extensive definition of employers eligible to maintain a 401(k) plan:

- Sole Proprietors
- Partnerships
- Corporations
- Federal Government Agencies
- Tax-Exempt Organizations – effective January 1, 1997

  Between May 6, 1986 and December 31, 1996, tax-exempt organizations (other than rural co-ops) could not establish a CODA.

- Indian Tribal Governments (and related entities) - effective January 1, 1997

- State or Local Governments – ONLY those with a CODA on May 6, 1986, may continue or establish new ones. (See the Field Directive on grandfathered CODAs, issued on March 12, 1992.)

Requirement to establish a simple 401k—100 employee rule

Any employer listed above intending to establish a SIMPLE 401(k) plan as described in IRC section 401(k)(11) must satisfy the 100-employee rule stated in IRC section 408(p)(2)(C)(i).

Definition of a CODA-G-01

What is a CODA

A CODA is an arrangement under which an eligible employee may make a cash or deferred election with respect to benefits under a plan. A plan that allows participants the right to elect to have contributions made to the plan on their behalf in lieu of cash or some other taxable benefit contains a CODA.

What is NOT a CODA

1. An arrangement under which amounts contributed at an employee's election are treated at the time of contribution as after-tax employee contributions, or

2. The only elections available are one-time irrevocable elections upon an employee's commencement of employment, or upon first becoming eligible under any plan of the employer, to have or not to have a specified amount contributed to the plan or any other plan of the employer for the duration of their employment

Failure of a CODA does not always disqualify plan

A CODA must be part of a profit-sharing plan, a stock bonus plan, a pre-ERISA money purchase plan or a rural cooperative plan. See IRC section 401(k)(1), (2) and (6). Since a CODA is part of a qualified plan, the failure of the CODA to satisfy IRC section 401(k) will not always result in the failure of the plan to satisfy IRC section 401(a).

For example, a CODA in a profit-sharing plan does not automatically disqualify the plan merely because the CODA failed the ADP test, although, in such case, the plan will most likely have failed to follow its terms, providing alternative grounds for disqualification.

A CODA that is part of a DB plan

A CODA that is part of a defined benefit plan would disqualify the entire plan because such plans are not permitted to contain CODAs.

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Definition of a CODA-G-01, Continued

Confusion of 401k terminology

Sometimes the term "section 401(k) plan" is used to denote a plan that properly contains a CODA **and** that may or may not provide for one or more types of other contributions, such as employee after-tax contributions, employer matching contributions and nonelective contributions.

However, under the regulations, a "section 401(k) plan" is that portion of a plan consisting only of elective contributions, and a "CODA" is the portion of a plan consisting of elective contributions plus QNECs and QMACs that are treated as elective contributions.

Examination steps-eligible employer and eligible plan

(1) Review the employer's type of entity to verify that the employer is eligible to maintain a CODA.

(2) Determine if the plan contains a CODA.

(3) If a CODA exists, determine whether the plan is eligible to include a CODA (e.g., a profit-sharing, stock bonus, pre-ERISA money purchase plan). If the plan is not eligible to include a CODA, the entire plan is not qualified.

(4) If the plan is eligible to have a CODA, determine whether the CODA is qualified or non-qualified. If non-qualified:

a. Check whether the elective contributions were reported as wages in the year withheld from compensation, using IDRS research if necessary.

b. Check whether the plan satisfied the coverage and nondiscrimination rules of IRC sections 410(b) and 401(a)(4), rather than the special IRC section 401(k) coverage nondiscrimination rules, counting the elective contributions as employer contributions.

Verify plan document for issues, such as compensation, eligibility etc-G-02.

Overall audit step

Verify that the plan document contains proper IRC 401(k) provisions including those relating to the definition of compensation, and requirements relating to eligibility, vesting, distributions, and top- heavy minimums (N/A for SIMPLE).

If the plan is not a Safe Harbor or SIMPLE plan, review the plan provisions with respect to the ADP test and correction. Incorp. by reference

Plan provisions-overview

It is important to fully understand the terms of the plan before proceeding with the examination.

Below are the technical issues that should be considered when checking the form of the plan for compliance.

Compensation definition-G-02

Compensation definition-distinction between plan and 401(k)

For all plan purposes, compensation is limited by IRC section 401(a)(17) ($160,000 for 1999, $170,000 for 2000 and 2001, and $200,000 for 2002).

The definition of compensation in the plan used **for making deferrals** can be any definition of compensation.

> Compensation used in the ADP test **must satisfy IRC section 414(s),** and can either include or exclude elective contributions deferred during the year.

The definition of compensation in Reg. 1.414(s)-1 makes reference to IRC section 415(c)(3), which includes elective deferrals in compensation (IRC section 415(c)(3)(D)).

> However, Reg. 1.414(s)-1(c)(3) contains a safe harbor alternative definition of compensation that does not include elective deferrals. Either definition of compensation satisfies IRC 401(k) for purposes of the ADP test.

Different definitions of compensation

The Code and regulations under IRC section 414 provide for specific definitions of compensation that satisfy IRC section 414(s). These are the following:

415(c)(3) definition

Compensation within the meaning of IRC section 415(c)(3). For plan years beginning after January 1, 1998, compensation under IRC section 415(c)(3) includes

- elective deferrals as defined in IRC section 402(g)(3), and
- any amount which is contributed or deferred which is not includible in gross income by reason of IRC sections 125, 132(f)(4), or 457.

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Compensation definition-G-02, Continued

415(c)(3) Compensation excluding elective deferrals

Compensation within the meaning of IRC section 415(c)(3) but excluding any amount contributed pursuant to a salary reduction agreement and which is not includible in gross income under IRC sections 125, 132(f)(4), 402(e)(3), 402(h), or 403(b).

415(c)(3) compensation reduced by ALL of the following

Compensation within the meaning of IRC section 415(c)(3) reduced by **ALL** of the following items:

- reimbursement or other expense allowances,
- fringe benefits (cash and noncash),
- moving expenses,
- deferred compensation, and
- welfare benefits

.

Possible modifications

The 415(c)(3) compensation modified above can also be modified to include employee contributions described in IRC section 414(h)(2).

Any definition of compensation that satisfies the definitions above and modified to exclude any portion of the compensation of some or all of the employer's highly compensated employees (HCEs).

Alternative definitions of compensation

Regulation 1.414(s)-1(d) provides for alternative definitions of compensation that satisfy IRC section 414(s).

This section states that in addition to the specific definitions of compensation that satisfy IRC section 414(s), any definition of compensation satisfies IRC section 414(s) with respect to employees (other than self-employed individuals treated as employee under section 401(c)(1)) if the definition:

- Does not by design favor HCEs,
- Is reasonable within the meaning of regulation 1.414(s)-1(d)(2),
- Satisfies the nondiscrimination requirement of regulation
- 1.414(s)-1(d)(3)

Eligibility-G-02

Eligibility requirements-only one year for 401k

The general rules under IRC section 410(b), requiring up to 2 years of service for eligibility (immediate vesting applies), apply to non-CODA portions of the plan, such as profit-sharing contributions, matching contributions or QNECs.

IRC section 401(k)(2)(D) provides that a CODA may not have a minimum service requirement for participation that is greater than 1 year.

Retroactive amendments to the CODA eligibility provisions may be made in certain circumstances. See Workpaper G09 regarding coverage.

Vesting-G-02

Vesting requirements-100% at all times for elective deferrals

Under IRC sections 401(k)(2)(C) and 401(k)(3)(D)(ii), an employee's interest in elective contributions, QNECs, and QMACs must be nonforfeitable when made.

> Thus, an employer may not reclassify a particular contribution after it was made as a nonforfeitable contribution and call it a QNEC in an attempt to satisfy the ADP test for a year.

Exception to 100% vesting rule for amounts in excess of 402(g) etc.

However, an exception to this nonforfeitability rule is provided in IRC sections 401(k)(8)(E) and 411(a)(3)(G). This exception allows a plan to forfeit a vested or non-vested matching contribution made on account of an elective contribution or employee contribution that is treated as:

- an excess deferral (amounts in excess of the 402(g) limits),
- an excess contribution (amounts in excess of what is permitted under the ADP test) or
- an excess aggregate contribution (amounts in excess of what is permitted under the ACP test).

Distribution requirements-G-02

Distribution requirements

IRC section 401(k)(2)(B) provides the elective contributions may only be distributed on:

- death,
- disability,
- separation from service, or
- events described in IRC section 401(k)(10).
- Attainment of 59 1/2

Events in section 401(k)(10)

The events in IRC section 401(k)(10) are:

- termination of the plan,
- disposition of corporate assets and
- sale of a subsidiary by the corporation maintaining the plan.

To be distributable upon one of these events the elective contributions must be distributed in a lump sum and, except for plan termination, the transferor corporation must continue to maintain the plan.

EGTRRA changes to distribution requirements

Changes made by EGTRRA effective after 12/31/01 (See Notice 2002-4):

The phrase "separation from service" was changed to "severance from employment", eliminating the same desk rule in Rev. Rul. 2000-27, applicable to distributions made after December 31, 2001, regardless of when severance from employment occurred.

The disposition of assets provision in IRC section 401(k)(10) was eliminated.

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Distribution requirements-G-02, Continued

Same desk rule-background

Rev. Rul. 2000-27 (known as the same desk rule) provides that a separation from service can occur when an employer disposes of less than substantially all the assets of a trade or business. The ruling also describes exceptions to the same desk rule.

This same desk rule was eliminated by EGTRRA effective after 12/31/01.

Distribution upon 59 1/2

Contributions made to a CODA that is part of a profit sharing or stock bonus plan may be distributed upon attainment of age 59½.

Distribution of any contribution that could be used in the ADP test (i.e., QNECs or QMACs) must be similarly restricted.

Hardship distributions

Distribution of elective contributions in the case of hardship may be allowed in profit sharing or stock bonus plans. However, as a general rule, QNECs, QMACs and earnings on QNECs, QMACs and elective contributions **may not** be distributed on account of hardship.

> The regulations permit a plan to provide a grandfather rule for earnings, QNECs and QMACs accrued prior to 12/31/88, (or, if later, the end of the last plan year ending before 7/1/89).

Other employer contributions, outside the CODA, are not subject to these restrictive hardship rules.

> Thus, a profit-sharing plan could have one set of rules for hardship distributions from the CODA and another, less restrictive, set of rules for other non-CODA contributions.
>
> Although most do, a CODA is not required to provide for hardship distributions at all. The determination of a hardship can be made using either general hardship distribution standards or deemed hardship distribution standards, both as described in the 401(k) regulations.

Top heavy requirements-G-02

Top heavy requirements

CODAs (but not SIMPLE 401(k) plans) are subject to the top-heavy rules in IRC Section 416. If a plan containing a CODA is top-heavy, then the plan must:

a) Vest contributions that are not immediately fully vested at a certain minimum rate and

b) Provide each non-key employee who is employed on the last day of the plan year with a contribution equal to 3 percent of the employee's compensation for the entire year or, if lesser, the same percentage as the key employee with the highest percentage contribution.

Thus, if the highest percentage contribution given to a key employee was 4 percent, then non-key employees must each receive a 3-percent contribution. But if the key employee with the highest percentage contribution got a 2-percent contribution, then non-key employees need only be given a 2-percent contribution.

Elective contributions of key employees taken into account

Elective contributions on behalf of key employees must be taken into account in determining the minimum contribution required for non-key employees, but elective contributions of non-key employees do not count towards satisfying the minimum contribution.

For example, assume the only contributions made to a profit-sharing plan for a year were elective contributions and all participants, keys and non-keys, made deferrals of 2 percent.

If the plan was top-heavy, the employer **would have to make a** 2-percent contribution to the plan for all the non-key employees eligible to participate regardless of whether they made any elective contributions or not (See Regs. 1.416–1, M–20).

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Top heavy requirements-G-02, Continued

QNECs satisfies top heavy minimum contribution

QNECs, however, whether or not used to satisfy the ADP test, can be used to satisfy the non-key minimum contribution (See Regs. 1.416–1, M–18).

EGTRRA change to matching contributions

Non-key employee matching contributions used in the ACP test (and QMACs used in the ADP test) are not counted towards satisfying the non-key minimum contribution.

EGTRRA allows matching contributions to be used to satisfy the top heavy minimum contribution requirements beginning in 2002.

If there are two plans

If the top-heavy minimums are provided in another plan, and the eligibility requirements are not the same for both plans, then eligible participants in the section 401(k) plan may not be receiving the minimum benefit in the other plan. Thus, the eligible participants in the 401(k) plan must receive a minimum benefit in the section 401(k) plan.

ADP test and correction-G-02

Plan document must provide certain requirements

The plan document must contain provisions that the ADP test will be satisfied and the method of correction that will be used if needed. The ADP test itself may be incorporated by reference or spelled out in the plan. If the plan document contains the distribution to HCEs as the method to correct any ADP excesses, the plan must be amended (by the GUST 401(b) period) to reflect the new dollar leveling method. The document must also state which testing method is used (prior year or current year).

Examination steps-plan provisions—G-02

Overview

Agents should verify by close inspection of the applicable plan sections that the plan document contains all the proper definitions and requirements prior proceeding with the examination.

Keep in mind that during any remedial amendment period, the plan document may not contain the current language but operations must comply with all law in effect at that time.

Eligibility requirements of CODA, G-03

Overall audit step

Verify that the CODA eligibility requirements satisfied IRC 401(k)(2)(D) in form and operation.

Introduction

IRC section 401(k)(2)(D) provides that a 401(k) plan is a plan:

> "which does not require, as a condition of participation in the arrangement, that an employee complete a period of service with the employer (or employers) maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to subparagraph (B)(i) thereof)"

Thus, a 401(k) plan must not provide a service requirement greater than 1 year of service for the 401(k) portion of the plan.

Examination steps

If the eligibility requirements of the plan are the same for all portions of the plan, the eligibility issue can be addressed in the workpapers included in section B of the Form 5773.

Explain in G03 and refer to workpaper B.

If the eligibility requirements of the CODA portion of the plan are not the same as the rest of the plan, follow the applicable exam steps below:

(1) Review the relevant source documents (payroll files, personnel files, census files, etc.) to determine the correct hire date for employees who become eligible to make deferrals during the plan year under exam.

(2) Review election forms for eligible employees and verify the election date.

(3) Review payroll files and plan files to determine if deferrals are made after the election date.

(4) Verify that the correct entry date for elective deferrals, as defined by the plan, is followed.

Vesting requirements in operation-G-04

Overall audit step

Verify that the CODA vesting requirements were satisfied in operation.

Introduction

Under IRC sections 401(k)(2)(C) and 401(k)(3)(D)(ii), an employee's interest in elective contributions, QNECs, and QMACs must be nonforfeitable when made.

Thus, an employer may not re-designate a particular contribution as a nonforfeitable contribution and call it a QNEC as needed to satisfy the ADP test for a year.

Can forfeit a vested match if made on account of excess deferrals etc.

IRC sections 401(k)(8)(E) and 411(a)(3)(G) provide an exception to this general rule of nonforfeitability. A plan can forfeit a vested or non-vested matching contribution made on account of an elective contribution or employee contribution that is treated as:

- an excess deferral,
- an excess contribution (amounts in excess of what is permitted under the ADP test) or
- an excess aggregate contribution (amounts in excess of what is permitted under the ACP test).

Examination steps-Vesting

(1) Verify that any amounts used to satisfy the ADP test (elective contributions, QNECs, and QMACs) are 100% vested at all times.

(2) Check that matching contributions that relate to corrective distributions of elective or employee contributions to satisfy the ADP or ACP test are forfeited (or distributed, if necessary to satisfy the ACP test).

Verify no elective deferrals made prior to date of CODA adoption—G-05

Overall audit step

Verify that no elective deferrals were made prior to the date that the CODA was adopted or the date that the participant signed a CODA agreement.

Introduction

The specialist is required to check the election forms to verify the date of election and the amount and/or percentage of compensation deferred and review the employer's payroll records to verify the correct commencement of deferrals.

Examination steps

(1) Review corporate documents or other enabling instruments to verify that the CODA was adopted and effective prior to any election taking effect.

(2) Review election forms for eligible employees and verify the election date.

(3) Review payroll files to verify that the correct amount/percentage is made and that the deferrals began after the election date.

Highly compensated employees correctly identified-G-06

Overall audit step

Verify that Highly Compensated Employees (HCEs) were correctly identified.

Introduction--statutory definition

Section 414(q)(1) as amended by the Small Business Job Protection Act of 1996, ("SBJPA") provides that an HCE is any employee who:

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

b) 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.

Compensation definition for determining HCE

For purposes of determining HCE status, the term "compensation" has the meaning given such term by §415(c)(3). As indicated later in the chapter, 415(c)(3) has several definitions.

- A definition that has all the inclusions of 1.415-2(d)(2) and excludes all other remuneration.

- A definition that meets 1.415-2(d)(10) (including only 1.415-2(d)(2)(i) and excluding items in –2(d)(3)), and

- definitions that meet 1.415(d)(11) (alternative definitions of safe harbor definitions—information required to be reported under 6041 etc., or section 3401 wages).

One of these definitions would be the starting point. For years beginning after January 1, 1998, 415(c)(3) compensation includes deferrals under 402(g) and amounts contributed or deferred and not includible in gross income by reason of sections 125, 132(f)(4) and 457.

For self-employed individuals, compensation shall be the participant's earned income as determined by §401(c)(2).

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Highly compensated employees correctly identified-G-06,
Continued

Top paid group

Pursuant to § 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.

An election pursuant to § 414(q)(1)(B)(ii) is a top paid election. This is an election under which an employee (who is not a 5-percent owner) who has compensation in excess of $ 80,000 (indexed) is **not an HCE** if the employee is not a member of the top-paid group.

Plan requirements for top paid election

The amendments made by § 1431 of SBJPA generally apply to years beginning after December 31, 1996. The top-paid group election made by an employer must apply consistently to the determination years of all plans of the employer that begin with or within the same calendar year. The election must be reflected in the plan's documentation (Notice 97-45).

How to determine HCEs under the top paid election

When determining the number of employees to be included in the top-paid group, begin with the total number of employees who performed services for the employer at any time during the year.

Then, the employer may subtract certain employees from that number. §414(q)(5) defines the employees that are excluded for these purposes.

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Highly compensated employees correctly identified-G-06,
Continued

Employees excluded from HCE consideration

The following employees shall be excluded—

(A) employees who have not completed 6 months of service (for this purpose, service in the immediately preceding year is taken into account),
(B) employees who normally work less than 17 ½ hours per week,
(C) employees who normally work fewer than 7 months during any year,
(D) employees who have not attained age 21,
(E) employees who are nonresident aliens with no U.S.-source earned income, and
(F) Collective bargaining employees (but only if such employees make up 90 percent or more of the employees and no such employees are covered by the plan).

The employer may elect to apply subparagraph (A), (B), (C), or (D) by substituting a shorter period of service, smaller number of hours or months, or lower age for the period of service, number of hours or months, or age than those specified above (including zero age and service requirement).

The employer may also choose not to exclude the Collective bargaining employees, referred to in subparagraph (F) (Regs. 1.414(q)-1T, Q&A 9).

Examples illustrating Top paid determination

Example 1 excluding employees for measuring the number in top paid group

Employer X has 200 active employees during the 1999 look back year, 100 of which normally work less than 17 ½ hours per week during such year and 80 of whom normally work less than 15 hours per week during the year.

X elects to exclude all employees who normally work less than 15 hours per week in determining the number of employees in the top-paid group. Thus, X excludes 80 employees **in determining the number of employees in the top-paid group**. X's top-paid group for the 1999 look back year consists of 24 employees (20% of 120).

All 200 of X's employees must then be ranked in order, by compensation received during the year. The 24 employees X paid the greatest amount of compensation during the year are top-paid employees with respect to X for the 1999 look back year and are the HCEs for the 2000 determination year.

Example 2- same facts, different exclusion

The facts are the same as in the above example, except that Employer X chose to exclude all 100 employees who normally work less than 17 ½ hours per week during the year. Thus, X would include 20 employees in the top-paid group (20% of 100). All 200 employees would then be ranked in order, by compensation received during the year, and the 20 employees with the highest compensation are in the top-paid group for the 1999 look back year.

Example 3, did not exclude any employees

The facts are the same as in Example 1, except that X chose to exclude no employees on the basis of a minimum service requirement. Thus, X would include 40 employees in the top-paid group (20% of 200).

Again all 200 employees would then be ranked in order, by compensation received during the year, and the 40 employees with the highest compensation are in the top-paid group for the 1999 look back year.

After the number of employees in the top-paid group has been determined, those employees with the highest compensation should be identified. The exclusions used in determining the number of employees in the top-paid group are not applicable [Reg §1.414(q)-1T, Q&A 9(c)].

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Examples illustrating Top paid determination, Continued

Example 4- exclude employee in determining number of top paid, but cannot otherwise exclude employee

ABC Company sponsors a 401(k) plan and, for purposes of determining HCEs, made the top-paid group election. Employee A is hired on 7/20/00, and makes $105,000 during the look-back year ending 12/31/00.

Because she worked fewer than six months as of 12/31/00, Employee A is excluded in determining the number of employees in the top-paid group. However, as long as her compensation places her in the top 20 percent of employees for the look-back year when ranked on the basis of compensation, she is considered an HCE for the plan year beginning 1/1/01.

HCE determination—calendar year election

Introduction

An employer maintaining a plan on a fiscal year basis may make a calendar year data election for a determination year.

The effect of the calendar year data election is that the calendar year beginning with or within the look-back year is treated as the employer's look-back year for purposes of determining whether an employee is an HCE on account of the employee's compensation for a look-back year under §414(q)(1)(B).

How long calendar election applies

A calendar year data election, once made, applies for all subsequent determination years unless changed by the employer and is subject to the same consistency rules as the top-paid group election. The change may be made without IRS approval. The plan document must reflect the election, and any change in the election must be accomplished by plan amendment (Notice 97-45).

Calendar year election does not apply to 5% owners

The calendar year data election made by an employer does not apply in determining whether the employer's employees are HCEs on account of being 5-percent owners. Accordingly, if an employee is a 5-percent owner in either the look-back year or the determination year, then the employee is an HCE without regard to whether the employee's employer makes a calendar year data election (Notice 97-45).

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HCE determination—calendar year election, Continued

Example 5-no top paid or calendar year election

Employer X has a single plan (Plan A) with an April 1 to March 31 plan year end. Employer X made no election to use the calendar year for the determination period and did not make the top-paid group election.

Therefore, in determining the group of HCEs for the April 1, 1999 to March 31, 2000 plan year, the employees that were

- 5% owners during the determination year (the plan year ending March 31, 2000) or the preceding plan year and
- those earning over $80,000 during the preceding plan year (the plan year ending March 31, 1999)

were included. Employer X had 5 employees who were 5% owners during the determination year and 10 other employees who earned in excess of $80,000 during the preceding plan year. Thus, X had 15 HCEs for the determination year.

Example 6, same facts, but employer makes calendar year election

Assume the same facts given above, except that X elected to use the calendar year to determine HCEs.

Therefore, in determining the group of HCEs for the April 1, 1999 to March 31, 2000 plan year, the data from the fiscal years ending March 31, 2000 and 1999 is used to determine 5% owners.

The data from the calendar year ending December 31, 1999 is used to determine those that earned in excess of $80,000.

X still had 5 employees who were 5% owners during the fiscal years ending March 31, 1999 and 2000 and 8 employees who earned compensation in excess of $80,000 **during the calendar year ending December 31, 1999** (due to bonuses paid late in the fiscal year). Thus, X had 13 HCEs for the determination year.

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HCE determination—calendar year election, Continued

Example 7-prior year method is default method

Since 1998, Employer D has maintained a qualified cash or deferred arrangement under §401(k) (Plan Q). Plan Q has a calendar plan year. Employer D has never made a calendar year data election or a top-paid group election for Plan Q and has never had a 5-percent owner.

Under §401(k)(3)(A)(ii), as amended by the SBJPA, unless an employer elects to use current year data for all eligible employees, the actual deferral percentage (ADP) test for the plan year is applied by comparing the ADP for all eligible HCEs for the plan year to the ADP for all other eligible employees (NHCEs) for the preceding plan year. Employer D has not elected to use current year data for the NHCEs for the 2000 calendar year.

(b).

Example 8-how to run the prior year method

In conducting the ADP test for the 2000 calendar year, Employer D compares

- the ADP for the 2000 calendar year for the group of employees who had compensation above $80,000 (as adjusted) for the 1999 calendar year, and who are eligible under the plan for the 2000 calendar year, with

- the ADP for the 1999 calendar year for the group of employees who were NHCEs for the 1999 calendar year and who were eligible under the plan for the 1999 calendar year.

To determine the NHCEs to determine the ADP for 1999 year, Employer D would have previously determined who the HCEs were for the 1999 calendar year, that is, the employees of Employer D who had compensation above $80,000 (as adjusted) for the **1998** calendar year.

The NHCEs for the 1999 calendar year are those employees who were employees in the 1999 calendar year and who were determined not to be HCEs. The NHCEs for the 1999 ADP are those employees whose compensation did not exceed $80,000 for the 1998 calendar year.

HCEs--Determining 5% owners

Introduction

Determining 5-percent ownership involves attribution of ownership interest to family members. The definition of a 5-percent owner in §414(q)(2) refers to §416(i)(1), which in turn refers to the attribution rules of §318.

Section 318 attribution rules to determine 5% owners

Under the rules of §318, an individual is considered to own any stock owned directly or indirectly by the individual's spouse, children, grandchildren or parents. Although this is not the only attribution rule under section 318, this rule is the most common rule that EP agents should run across.

318 Attribution rules continue to apply, and were not repealed under family aggregation

These statutory provisions relating to the definition of 5-percent owner under §414(q)(2) **are different** from the family aggregation rules under former §414(q)(6).

The 318 attribution rules **are unaffected** by the repeal of the family aggregation rules under §1431(b)(1) of SBJPA. The family aggregation rules treated members aggregated as one HCE. The attribution rules treat the members as separate HCEs, but measure whether an individual is an HCE through stock ownership of a family member.

Example illustrating 5% owner

Employer X maintained a 401(k) plan (Plan A). Employees A and B each own 50% of Employer X and are not related to each other. Plan A has a calendar year plan year. During 1999, no persons that were related to Employees A and B were employed. Thus, 2 employees were HCEs for the 1999 plan year due to being 5% owners.

Example illustrating 318 attribution rules

The facts are the same as in previous example, except that during 1999, two employees were related to the 5% owners. Employee C was the daughter of Employee A and Employee D was the spouse of Employee B.

Thus, 4 employees were HCEs for the 1999 plan year due to being 5% owners.

Examination steps-HCEs

Examination Steps

1. Request a list of owners of the plan sponsor and the percentage of ownership for the current and prior year and compare the list with the HCEs shown on the ADP test.

2. Review payroll records or W-2 forms of the prior year to determine which employees had compensation from the employer in excess of $80,000 (indexed).

3. If the top paid group election was made, review the plan document and amendments to verify such election was made, then further review payroll records or W-2s to verify which employees were in the top paid group for the preceding year.

Safe Harbor 401(k)—G-07

Overall audit step

Is the plan a Safe Harbor 401(k) Plan described in IRC 401(k)(12)? If yes, was the plan qualified in form and operated in accordance with the plan document? Verify that employer matching contributions (basic or enhanced) or nonelective contributions satisfied the safe harbor. Also, verify that the notice requirement described in IRC 401(k)(12)(D) was met.

Plan administrator must correct to follow terms

If the Safe Harbor Method was used, but not satisfied, the administrator must correct to follow the terms of the plan (can not use ADP/ACP testing). If this is a Safe Harbor Plan, skip steps G08, G10, and G11 only.

Background on safe harbor

Beginning in 1999, safe harbor 401(k) plans became available to employers. The Service has published two notices on safe harbor plans, Notice 98-52 and Notice 2000-3. These two notices provide guidance on the design-based alternative or "safe harbor" methods under IRC sections 401(k)(12) and 401(m)(11) for satisfying the ADP test and the ACP test under IRC sections 401(k) and 401(m).

Note that IRC sections 401(k)(12) and 401(m)(11) provide guidance on the contributions required for NHCEs, but a safe harbor plan will provide for uniform contribution formulas that apply to both NHCEs and HCEs.

Notice 2000-3 provides guidance, in the form of 11 questions and answers, on the safe harbor methods. These Q&As are in section III of the notice, and they either modify Notice 98-52 or provide additional guidance on the safe harbors. Sections I and II of the notice explain the purpose of the notice, summarize the contents of the notice and provide background information.

Continued on next page

Safe Harbor 401(k)—G-07, Continued

With safe harbor, ADP deemed to be satisfied

A safe harbor 401(k) plan is deemed to satisfy the ADP test (and usually the ACP test as well). If a CODA satisfies the rules in IRC section 401(k)(12) and also the rules in IRC section 401(m)(11), the plan is deemed to satisfy both the ADP test and the ACP test.

A plan can satisfy the ADP safe harbor without satisfying the ACP safe harbor, but a plan cannot satisfy the ACP safe harbor without satisfying the ADP safe harbor. A plan that uses the safe harbor methods to satisfy the ADP or ACP test is treated as using the current year testing method for that plan year.

Safe harbor-401k, Plan provisions-G-07

When provision must be adopted

Generally, an employer that intends to use the safe harbor provisions for a plan year must adopt those provisions before the first day of that plan year. There is a special rule under Rev. Proc. 2000-27 for plans that want to retroactively apply the safe harbor provisions.

Section 4 of Rev. Proc. 2000-27, 2000-26 I.R.B. 1272 provides that 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.

> This amendment is retroactive to the first day of the 1999, 2000 or 2001 plan year, **to reflect the first use of the safe harbor methods**.

Plan can be amended as late as 30 days prior to the end of the year for nonelective contribution

Under 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.

> Such a plan is required to provide a regular safe harbor notice (with modified content) 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.

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Safe harbor-401k, Plan provisions-G-07, Continued

Plan without a 401k can be amended up to 3 months to include a safe harbor

Under 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.

Compensation definition-in general

Generally, the same definitions apply as are used in other CODAs. In the case of "compensation" the same definition applies for purposes of determining employer nonelective contributions. Thus, a uniform definition of compensation satisfying Regs. 1.414(s)-1 must be used for the ADP and ACP safe harbors for purposes of the

- basic and enhanced matching formulas,
- the nonelective contribution requirement, and
- the matching contribution limitations.

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 an IRC section 414(s) safe harbor definition of compensation). See section 1.414(s)-1(c)(2).)

Plan may use a reasonable definition of compensation for elective deferrals

With respect to elective contributions under a plan using the ADP safe harbor matching formula, each eligible NHCE may make elective contributions under a "reasonable definition" of compensation as defined under Regs. 1.414(s)-1(d)(2).

Such definition is not required to satisfy the nondiscrimination requirement of Regs. 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.

Continued on next page

Safe harbor-401k, Plan provisions-G-07, Continued

Compensation cannot be limited to a dollar amount-but can limit compensation to eligibility

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.

Example 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 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 Regs. 1.414(s)-1(d)(2), 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 IRC section 415(c)(3).

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 IRC 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.

Continued on next page

Safe harbor-401k, Plan provisions-G-07, Continued

Vesting requirements and withdrawal restrictions

The plan must specify that the safe harbor matching and nonelective contributions are nonforfeitable when made and subject to the withdrawal restrictions of IRC section 401(k)(2)(B).

Thus, such contributions and earnings cannot be distributed earlier than:

- separation from service,
- death,
- disability,
- an event described in IRC section 401(k)(10),
- or age 59 1/2 for a profit sharing or stock bonus plan.

ADP Test Safe Harbor Requirements-G-07

Introduction-must satisfy contribution and notice requirement

To satisfy the ADP safe harbor, a CODA must satisfy:

- the safe harbor contribution requirement, and
- the notice requirement of IRC section 401(k)(12).

Contribution 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.

Contributions must be made on behalf of all eligible employees

Safe harbor matching or safe harbor nonelective contributions, whichever is used, must be made on behalf of all eligible employees under the plan; meaning.

For example, the plan cannot restrict these contributions to employees employed on the last day of the plan year or to employees who have at least 1,000 hours of service in the plan year.

Contribution requirements cannot use integration

The safe harbor contribution requirement must be satisfied without regard to the integration provisions of section 401(l).

ADP Safe harbor-Matching contribution requirement-G-07

Introduction

A plan may satisfy the matching contribution requirement by providing for either the

- basic matching formula, or
- an enhanced matching formula.

Basic matching formula

The basic matching formula provides matching contributions on behalf of each eligible NHCE in an amount equal to:

- 100 percent of the employee's elective contributions up to 3 percent of the employee's compensation, and
- 50 percent of the employee's elective contributions that exceed 3 percent of the employee's compensation but do not exceed 5 percent of the employee's compensation.

Enhanced matching formula

An enhanced matching formula provides matching contributions for each eligible NHCE under a formula that provides an aggregate amount of matching contributions at least equal to:

- the aggregate amount that would have been provided under the basic matching formula at any elective contribution rate, and
- the rate of matching contributions may not increase as an employee's rate of elective contributions increases.

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ADP Safe harbor-Matching contribution requirement-G-07,
Continued

Plan can provide for discretionary matches

Note that a plan that contains a formula that satisfies the ADP test safe harbor will not fail the ADP test safe harbor because the plan also provides for discretionary matches. See below or section VI.B.4 of Notice 98-52 for the limitations on the amount of discretionary matches under the ACP test safe harbor.

Rate of match for HCEs cannot be greater than rate for NHCEs

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 illustrating matching

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.

Continued on next page

ADP Safe harbor-Matching contribution requirement-G-07,
Continued

Example illustrating matches

A plan covers Divisions A and B, both of which have NHCEs and HCEs. 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. Thus, the plan would not satisfy the ADP test safe harbor (see example 5 under section V.B.3 of Notice 98-52).

Permitted Restrictions and reductions on safe harbor matches

Generally, the matching contribution requirement is not satisfied if elective contributions by NHCEs are restricted. However, the following restrictions on elective contributions **are permitted**:

a) Certain reasonable limits on the periods during which employees can make or change their deferral elections;

b) Certain limits on the amount of elective contributions that can be made, for example, an employer can require that elective contributions be made in whole percentages of pay or in whole dollar amounts;

c) Certain limits on the types of compensation that may be deferred; and

d) Limits on elective contributions to satisfy IRC section 402(g) or 415 or on account of suspensions due to hardship distributions or withdrawals of employee contributions.

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ADP Safe harbor-Matching contribution requirement-G-07,
Continued

Conditions on restrictions

Despite all of the restrictions just described above, there are certain conditions that must be satisfied.

For example, as discussed earlier, although a plan sponsor may limit the amount of elective contributions, the employer must permit each eligible NHCE to make sufficient elective contributions to receive the maximum amount of matching contributions available under the plan. For an explanation of restrictions on types of compensation that may be deferred, see the definition of compensation above or section V.B.1.c.iii.

Amendment permitted to reduce or eliminate matches

Under Q&A-6 of Notice 2000-3, a safe harbor plan using matching contributions to satisfy the safe harbor contribution requirement can be amended during a plan year to prospectively reduce or eliminate matching contributions and instead use the current year testing method, provided certain notice and election requirements are satisfied.

Non-elective contribution requirement-401k safe harbor-G-07

Explanation

An alternative to the matching contribution requirement that can also satisfy the safe harbor contribution requirement is the nonelective 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 NHCE in an amount equal to at least 3 percent of the employee's compensation.

Notice requirements-safe harbor 401k-G-07

Introduction

The second requirement necessary to satisfy the ADP test safe harbor is the notice requirement.

Such 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 both:

    - 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

For the content requirement, the notice must describe the safe harbor method used by the plan, making elections, any other plans involved, etc. (with 1999 transition relief).

See Q&As -7 and -8 of Notice 2000-3 for information on satisfying the content requirement using electronic media and referencing the plan's summary plan description.

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Notice requirements-safe harbor 401k-G-07, Continued

Timing requirement

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

> 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). Transition relief for 1999 and 2000 is provided.

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.

> This notice would allow the plan to adopt the nonelective contribution requirement within 30 days prior to the end of the 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.

Multiple CODAs, multiple plans, 401k safe harbor-G-07

Introduction

For employers maintaining multiple plans, the ADP test safe harbor matching contributions or nonelective contributions may be made to the plan that contains the CODA or to another defined contribution plan that satisfies IRC section 401(a) or section 403(a).

If contributions made to another DC plan-same eligibility conditions

If safe harbor contributions are made to another defined contribution plan, the safe harbor contribution requirement must be satisfied in the same manner as if the contributions were made to the plan that contains the CODA.

Consequently, each employee eligible under the plan containing the CODA must be eligible under the same conditions under the other defined contribution plan. Thus, both plans must have identical eligibility/participation requirements.

Plans must have the same plan year

In order for safe harbor contributions to be made to another defined contribution plan, that plan must have the same plan year as the plan containing the CODA. However, there is an exception for plans containing CODAs in the case of plan years beginning before 1/1/2000 if:

a) The safe harbor contribution is allocated as of a date within the plan year of the plan containing the CODA, and

b) The contribution is made no later than 12 months after the close of that plan year.

Plans do not have to be capable of being aggregated

The plan receiving the safe harbor contributions does not have to be capable of being aggregated with the plan containing the CODA for purposes of section 410(b).

Safe harbor contributions can only be counted once

In addition, safe harbor matching or nonelective contributions cannot be used to satisfy the safe harbor contribution requirements with respect to more than one plan. Thus, these contributions can be used only once to satisfy the safe harbor requirement.

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Multiple CODAs, multiple plans, 401k safe harbor-G-07, Continued

Rules of aggregation and disaggregation apply

The rules for aggregating and disaggregating CODAs and plans also apply for purposes of the ADP/ACP test safe harbor requirements.

Thus, all CODAs included in a plan are treated as a single CODA that must satisfy the safe harbor contribution requirement and the notice requirement.

> Two plans (within the meaning of Regs. 1.410(b)-7(b)) that are treated as a single plan under permissive aggregation are treated as a single plan for purposes of the safe harbor methods.

Conversely, a plan (within the meaning of IRC section 414(l)) that includes a CODA covering both collectively bargained employees and noncollectively bargained employees **is treated as two separate plans** for purposes of IRC section 401(k). Thus, the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor.

Rule of HCE receiving great rate of match could be violated

The following situation could result in the violation of the rule prohibiting HCEs receiving a greater match than the NHCEs.

- Assume an HCE is simultaneously an eligible employee under two plans maintained by an employer for a plan year, only one of which is intended to satisfy the ADP/ACP test using the safe harbor methods, and
- the matching contribution formula of the plan that is **not using the safe harbor** methods provides **greater matching contributions** than the formula under the plan that is intended to satisfy the ADP/ACP test using the safe harbor methods.

Examination steps—401k safe harbor-G-07

Review plan document

Review the plan document and any amendments to determine if the plan is a safe harbor 401(k) plan and which contribution requirement, matching or nonelective, is used to satisfy the safe harbor contribution requirement.

If contributions will be made to another plan of the employer, verify that the plan identifies the recipient plan.

Verify that the plan's definition of compensation satisfies the special rules for safe harbor plans and that safe harbor contributions are fully vested and subject to the withdrawal restrictions of Code section 401(k)(2)(B).

Examine contributions and allocations

Examine contributions and participant allocation schedules to determine which contributions are safe harbor contributions.

- If safe harbor nonelective contributions, verify that the contributions equal to at least 3% of each eligible NHCE's compensation.
- If safe harbor matching contributions, verify that the contributions satisfy the basic matching formula or the enhanced matching formula as provided for in the plan document or amendment.
- If discretionary matching contributions are also made, verify that they were properly limited in accordance with section VI.B.4 of Notice 98-52

Examine W-2s

Examine Forms W-2 to verify participant compensation, consider the plan's definition of compensation and verify that allocations were made based on the proper compensation amounts.

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Examination steps—401k safe harbor-G-07, Continued

Examine safe harbor notices

Examine the safe harbor notices, verifying that the content satisfies the safe harbor requirements. For the requirements in the use of electronic media for the safe harbor notices, refer to Q&A-7 of Notice 2000-3.

Verify that the safe harbor notices satisfy the timing requirements. If the plan uses the deemed timing period, verify that each notice was given to the employee within the applicable 30 to 90 day period. Transition relief provided for 1999 and 2000.

For plans that reserve the option of using the safe harbor nonelective contributions, verify that the notice content and timing satisfy the requirements contained in Q&A-1 of Notice 2000-3.

Examine plan amendments

Examine plan amendments made during the year to determine if the plan was amended to reduce or eliminate safe harbor matching contributions. If so, verify that a supplemental notice was given to all eligible employees that satisfied the content and timing requirements of Notice 2000-3, Q&A-6.

Simple 401k plans—G-08

Overall audit step

Is the plan a SIMPLE 401(k) Plan described in IRC 401(k)(11)? If yes, was the plan qualified in form and operated in accordance with the plan document? Verify that employee contributions were limited and that employer contributions (matching or nonelective) satisfied the SIMPLE requirements. Also, verify that the notice requirement described in (IRC 401(k)(11)(B)(iii)(II)) was met.

Plan must correct defect to follow its terms

If a SIMPLE plan failed to follow its terms, the administrator must correct to follow the terms of the plan (can not use ADP/ACP testing). If this is a SIMPLE plan, skip steps G10 & G11 only.

Overview-Simple 401k plans

IRC sections 401(k)(11) and 401(m)(10) were added to permit SIMPLE section 401(k) plans beginning in 1997.

SIMPLE 401(k) plans provide employers with an alternative method of satisfying the nondiscrimination tests, as a SIMPLE 401(k) plan is deemed to satisfy the ADP and ACP tests and is not subject to the top-heavy requirements.

SIMPLE 401(k) plan requirements closely follow the requirements for SIMPLE IRA plans described in IRC section 408(p), with the exception that SIMPLE IRA plan contributions go directly to each employee's IRA and SIMPLE 401(k) plan contributions are made to the plan's trust.

Simple 401k requirements-G-08

Employer eligible to adopt Simple 401k plans

An employer that employed 100 or fewer employees earning at least $5,000 in compensation for the preceding year, with a two-year grace period provided in IRC section 408(p) (2) for growing employers, may only adopt the 401(k) SIMPLE provisions.

An employer who maintains another plan covering employees who are eligible to participate in the CODA using the 401(k) SIMPLE provisions may not adopt the 401(k) SIMPLE provisions.

Plan requirements-plan year and compensation definition

A plan containing SIMPLE 401(k) provisions must be maintained on a calendar year basis.

A special inclusive definition of compensation applies to SIMPLE 401(k) plans. See IRC section 408(p)(6). Basically, compensation is what is reported on an employee's Form W-2 for the year, including elective contributions. The compensation limit of IRC section 401(a)(17) applies to SIMPLE 401(k) plans.

Modification of deferral elections and notification requirements

Each eligible employee must be given the opportunity to make or modify a deferral election during the 60-day period prior to each January 1.

> For the first time an employee becomes eligible, the first 60-day period can be any 60-day period that includes the date he or she becomes eligible or the day before.

Prior to each election period, the employer must notify all eligible employees of their right to make deferral elections and whether the employer will be making a matching or nonelective contribution for the year.

Qualification requirements

Except for the ADP/ACP tests, and top heavy, all other qualification requirements of the Code continue to apply to a plan that contains 401(k) SIMPLE provisions including IRC sections 415, 401(a)(17), 404(a). Note that all other requirements applicable to 401(k) plans continue to apply, such as the distribution restrictions of IRC section 401(k)(2)(B).

Continued on next page

Simple 401k requirements-G-08, Continued

Contribution requirements

Elective deferrals are limited to $6,000 (indexed) per year and the employer must make either:

a) a matching contribution equal to the employee's salary reduction contributions, up to 3% of the employee's compensation for the year, or

b) a nonelective contribution for all eligible employees equal to 2% of the employee's compensation for the year. Employees earning less than $5,000 for the year can be excluded.

No contributions other than those described above can be made to a SIMPLE 401(k) plan.

All amounts contributed under 401(k) SIMPLE provisions must be nonforfeitable at all times.

Guidance

The Service issued guidance on SIMPLE 401(k) plans, including a model amendment, in Rev. Proc. 97-9. Additional requirements apply to plans adopting the model amendment including a special definition of compensation for purposes of the matching and nonelective contributions, notification and election period requirements and transitional rules for growing employers.

Examination steps-Simple 401(k), G-08

Inspect payroll records

Inspect the employer's payroll records, W-2s, 940, 941s, etc., for the preceding year to verify that the employer employed no more than 100 employees earning over $5,000 for the year preceding the year under examination, thus, making the employer an "eligible employer".

If the employer is not an eligible employer for the year under exam, inspect preceding years' payroll records to determine the last year the employer was an eligible employer.

If the year under exam is within two years following the last year the employer was an eligible employer (grace period), the employer is treated as an eligible employer.

Review eligibility of other employer plans

Review documents of all other plans maintained by the employer to verify that no employee covered under the SIMPLE 401(k) plan is also covered by any other plan of the employer.

Review Simple plan document

Review the plan document to verify the following:

a. the plan year is the calendar year,
b. the definition of compensation satisfies IRC section 408(p)(6),
c. elective contributions are properly limited ($6,000 as indexed),
d. the employer's choice of contribution (matching or nonelective),
e. there are no provisions for other contributions made to the plan, and
f. all contributions are fully vested.

Review allocation schedules

Review participant allocation schedules to verify that deferrals did not exceed $6,000 (as indexed) and that compensation figures were accurate, complying with IRC section 408(p)(6) as well as the plan.

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Examination steps-Simple 401(k), G-08, Continued

Verify employer contributions were made

Verify that the employer contribution was made in accordance with the method stated in the plan, either the matching or nonelective contribution.

If the matching method applies, verify that matching contribution allocations equaled the amount of deferrals or 3% of the employee's compensation, if less.

For nonelective contributions, verify that the contribution and allocation equals 2% of each eligible employee's compensation, whether or not the employee elected to make any deferrals.

For any eligible employee not receiving an allocation, inspect the W-2 for the year issued to the employee to verify that earned less than $5,000.

Review account statements

Review participant account statements to verify that all participants are fully vested in all contributions made under the plan.

Verify that no allocations were made from contributions other than employee deferrals and the employer's matching or nonelective contribution.

Review notices

Review the notices given to all eligible employees regarding elections to verify that the notice contained the required information and was provided in a timely manner.

Review the notices to verify compliance with the notification and election period requirements.

Review plan document

For a plan containing the Model Amendment SIMPLE 401(k) provisions of Rev. Proc. 97-9, review the plan document to verify that it contains the special definition of compensation and review the allocation schedule to verify the proper use of this definition of compensation.

If the employer is not an eligible employer, transitional rules, in certain circumstances, may extend the two-year grace period for employers adopting the model amendment.

401k coverage tests-G-09

Overall audit step

For all plans, verify that the CODA portion of the plan, by itself, satisfied one of the coverage tests under IRC 410(b) using the group of employees eligible to participate.

Verify that the CODA was properly aggregated and/or disaggregated in accordance with Reg. 1.410(b)-7(c) as modified by Reg. 1.401(k)-1(g)(11). If the plan did not meet coverage, verify that correction was made in accordance with Reg. 1.401(a)(4)-11(g)(3).

Special benefiting rule for purposes of coverage

In a CODA, each employee who is eligible to make an elective contribution is treated as ''benefiting,'' (i.e., covered), regardless of whether the employee elects to have deferrals made to the plan.

Eligible employees also include certain employees who are temporarily prohibited under the plan from making deferrals, such as a suspension following a hardship distribution.

Aggregation and disaggregation rules

Certain aggregation and disaggregation rules may apply when testing the CODA for coverage. For example, 401(k) and (m) portion of the plan must be disaggregated from the profit sharing plan. Each portion, the 401k, 401m and profit sharing plan must be separately tested for coverage.

However, when testing for coverage, a 401k portion of a plan maintained by the employer may be aggregated with another 401k portion of the plan, particularly if one of the 401k portion does not satisfy coverage (see case study below). If such 401k portions are aggregated, then the ADP test must be satisfied on an aggregated basis.

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401k coverage tests-G-09, Continued

Exclusion for terminating employees under1.410(b)-6(f)

The exclusion for terminated employees under section 1.410(b)-6(f) does not apply to the 401(k) portion of the plan.

For purposes of the 401(m) portion of the plan, the exclusion for terminated employees may apply. Thus, if:

- the 401(m) disaggregated plan only provides for matches and
- there is a minimum service requirement or last day rule,

the employee may not be an eligible employee. Consequently an employee excluded under 1.410(b)-6(f) is not included for coverage.

CODA portion itself must satisfy coverage

The CODA portion of the plan, by itself, must satisfy one of the coverage tests under IRC section 410(b), either:

- the ratio percentage test or
- the average benefits test.

Age and service conditions-in general

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)).

Special coverage rule for plans that allow earlier entry

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 tested separately. 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
- another plan containing covered employees who don't satisfy the maximum age and service conditions.

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401k coverage tests-G-09, Continued

Special early participation rule enacted by SBJPA for 401k/m plans-

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.

Aggregation rules

To satisfy the ratio percentage test, a CODA may be aggregated with another CODA if the CODAs:

- Have the same plan year,
- uses the same testing method (prior year or current year) and
- may be permissively aggregated under the IRC section 410(b) regulations.

However, a CODA may not be aggregated with any non-CODA.

An ESOP may not be aggregated with a non-ESOP or another ESOP.

Even if an employer maintains a CODA in both an ESOP and another plan, and an HCE participates in both, the CODAs cannot be aggregated.

Continued on next page

401k coverage tests-G-09, Continued

Disaggregation rules

Employees covered by a collective bargaining agreement must be disaggregated from employees not covered by a collective bargaining agreement for purposes of testing coverage.

Multiple collective bargaining units within the same plan may be disaggregated, but are not required to be and the combination of bargaining units used for testing must be reasonable and reasonably consistent from year to year. Equivalent rules apply to multi-employer plans.

Correction to coverage by retroactive amendment

Reg. 1.401(a)(4)–11(g)(3) provides that section 401(k) and section 401(m) plans may be retroactively amended to extend eligibility to employees for coverage purposes within 10½ months after the plan year in which there is a coverage problem.

Under this regulation, if a CODA needs to add some NHCEs to satisfy IRC section 410(b), the employer must make a QNEC contribution to each of the added employees equal to the average of the ADRs of the NHCEs who were eligible.

This retroactive correction feature cannot be used to correct other defects, such as a failure to satisfy the ADP test.

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401k coverage tests-G-09, Continued

Example illustrating coverage

The plan document contains language stating that only employees of Division A are eligible for participation in the section 401(k) plan. The only other division of the employer is division B. The employees of these two divisions make up the total number of employees of the employer's workforce.

Division A employs a total of 80 employees, 5 are HCEs and 75 are NHCEs. All employees of division A have satisfied the participation requirements for the section 401(k) plan and are eligible to make elective deferrals. Thus, all of Division A employees are considered benefiting, even though some of the employees may not have actually made elective deferrals.

Division B employs 25 employees and all are NHCEs.

The plan benefits at least 70% of employees who are not highly compensated employees (75/75 + 25 or 75/100 = 75%); therefore, the plan passes coverage without having to use the average benefits test.

Example illustrating coverage

Employer A maintains a plan that allows for elective contributions, matching contributions and employer discretionary profit-sharing contributions. Under the terms of the plan, all employees are eligible to make elective contributions and to receive matching contributions.

The employer makes a matching contribution on behalf of all employees making elective contributions. In addition, the employer made a discretionary profit-sharing contribution equal to 5% of each employee's compensation.

Under the disaggregation rules, each portion of the plan must be separately tested for coverage. All portions of the plan must satisfy coverage separately. In this case,

- the 401(k) portion satisfies coverage as 100% of all employees are benefiting.
- The 401(m) portion satisfies coverage as 100% of all employees are benefiting.
- The profit sharing portion satisfies the coverage rule as 100% of all employees are benefiting.

Case study-illustrating coverage-GO9-facts and data

Facts-employer sponsors two plans

Prestigious Law Firm sponsors two 401(k) plans with a matching feature,

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

Eligibility, last day rule, and match

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.

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.

Employee census of company

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

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

Break down of 130 active employee

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

Continued on next page

Case study-illustrating coverage-GO9-facts and data, Continued

Break down of 95 participants

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

Breakdown of terminated employees

- **2 Partners**, both HCEs--**1** partner had more than 500 hours
- **8 Support** Staff--**3** support staff had more than 500 hours
- **10 Associates--6** associates had more than 500 hours,

  Of those associates with more than 500 hours, 2 were HCEs.

Total of 20 terminated employees

Total 10 terminated with more than 500 hours

Table of terminated employees

2 partners, both HCEs	1 had greater than 500 hours
8 Support Staff	3 had greater than 500 hours
10 Associates	6 had greater than 500 hours, of those were 2HCEs
Total of 20	Total 10

Employees taken into account

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.

Continued on next page

Case study-illustrating coverage-GO9-facts and data, Continued

Terminating employees treated as excludable employees

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.

When an employee is treated as benefiting under the 401k

An employee is treated as benefiting under a section 401(k) and (m) plan if the employee is an eligible employee.

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

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Case study—Illustrating G-09, applying coverage requirements-401(k), (m) plan

Non-excludable NHCEs and HCEs

The **non-excludable** 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..

Determining eligible and excludable employees

First determine who is eligible and excludable under the plan

The **excludable** employees are:

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

35

The **non-excludable** employees (not necessarily benefiting under Plan 001) are:

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

115 non-excludable employees

Non-excludable HCEs

The following are all non-excludable 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 non-excludable HCEs

Continued on next page

Case study—Illustrating G-09, applying coverage requirements-401(k), (m) plan, Continued

Non-excludable NHCEs

Non-excludable NHCEs under the Example

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

66 total NHCEs

Case study-Determining ratio percentage—plan 001

Total employees Benefiting

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

HCE benefiting

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

NHCEs who are benefiting

The NHCEs who are benefiting are:

38 support staff (30 active and 8 terminating).

Determine the ratio percentage

Determining the ratio percentage of plan 001.. First, have to determine the benefiting percentages of both the HCEs and the NHCEs.

The ratio percentage formula is:

$$\frac{\text{NHCE benefiting percentage}}{\text{HCE benefiting percentage}}$$

Such percentage must be equal to or greater than 70% to satisfy the ratio percentage test.

Continued on next page

Case study-Determining ratio percentage—plan 001, Continued

Applying ratio percentage test to Plan 001

The following tables has the following information:

The Eligible column provides that total number nonexcludable and benefiting employees.

401(k) portion-plan 001

	NON-EXLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40(Partners)+30(Support staff) +25 (Associates)+20 (terminating employees)	40 partners+30+2 (Terminating partners)+8 (Terminating support staff)	
HCE	40 (Partners)+5 (Associates) 2 (Terminating partners)+2 (Terminating associates)	40 partners+2 (Terminating partners)	42/49=86%
NHCE	30active support+20 associates + 8(Terminating support)+8(TA)	30+8(Terminating support)	38/66=58%

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

THE (K) PLAN FOR 001 FAILS the ratio percentage test.

401(m)-001 portion

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40(Partners)+30(Support staff)+25(Associates)+20 (Terminating employees)	40+30+2 (Terminating partners)+8(Terminating support staff)	
HCEs	40(Partners)+5 Associates+2 (Terminating partners)+2 Terminating associates)	40+2(TP)	42/49=86%
NHCEs	30active support+20 associates + 8(Terminating support)+8(TA)	30+8(Terminating support)	38/66=58%

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

Case study—applying coverage requirements-profit sharing plan-001

Excludable employees

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 1year of service)
- 25 Associates (had less than 1 year of service)
- 10 terminating employees
  45 excludable employees

Non-excludable NHCEs and HCEs

The non-excludable NHCEs and HCEs are those employees who cannot be excludable under section 1.401(b)-6. Although they may be excluded from the plan, these employees are still taken into consideration for purposes of the coverage requirements.

Non-excludable employees

The non-excludable employees of the plan 001 are:

- 40 active partners
- 30 support staff
- 25 active Associates
- 10 Terminating employees
  105 non-excludable employees

Continued on next page

Case study—applying coverage requirements-profit sharing plan-001, Continued

Non-excludable HCEs

The following are all non-excludable 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

Non-excludable NHCEs

The non-excludable NHCEs are:

- 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).

Continued on next page

Case study—applying coverage requirements-profit sharing plan-001-001, Continued

Calculating ratio percentage

The following table calculates ratio percentage for the profit sharing plan.

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40 (Partners) +30 (Support) +25 (Associates) +10 (terminating)	40+30	
HCE	40 Partners+5 associates + 1 terminating partner +2 terminating associates	40 partners	40/48=83%
NHCE	30 support+20 associates +3 terminating support+4 terminating associates	30 support	30/57=53%

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

Case study—determining coverage-plan 002

Introduction

As stated in the above facts, Plan 002 is a 401k/m plan that only covers the associates. The plan does not have a profit sharing feature that is in Plan 001.

Nonexludable employees

The number of nonexcludable employees do not change—since they are the total nonexludable employees for the employer.

Non-excludable HCEs

The following are all non-excludable 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 (participants in plan 002).
  49 total non-excludable HCEs

Continued on next page

Case study—determining coverage-plan 002, Continued

Non-excludable NHCEs

The non-excludable NHCEs are:

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

Benefiting HCEs

The HCEs who benefit under Plan 002 are 5 HCE associates and 2 HCE terminating associates.

Benefiting NHCEs

The NHCEs who benefit under Plan 002 are 20 NHCEs associates and 8 Terminating associates.

Table determining coverage-plan 002 (401k/m plan only)

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40 (Partners) +30 (Support) +25 (Associates) +10 (terminating)	35 Associates	
HCE	40 Partners+5 associates + 2 terminating partner +2 terminating associates	5 associates and 2 terminating associates	7/49=14%
NHCE	30 support+20 associates +8 terminating support+8 terminating associates	20 Associates and 8 terminating associates	28/66=42%

RESULTS (NHCE%/HCE%) 42/14=exceeds 100% (must be $\geq$ 70% to pass coverage). Plan 002 satisfies the ratio percentage test.

Case study-same facts, aggregating plans 001 and 002

Introduction

The employer realizes that the 401(k) and (m) portion of Plan 001 does not satisfy coverage, and the 401(k) and (m) portion of Plan 002 satisfies coverage. The employer decides to aggregate the plans to see if Plan 001 would satisfy coverage. Thus, the Employer elects to treat the two plans as one under 1.410(b)-(7). With aggregation, now all the participants eligible to make elective deferrals for both plans are including in one test for coverage.

401k plan—aggregating plans 001 and 002

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40 (Partners) +30 (Support +25 (Associates)+20 (terminating)	40+30+25+20 (25 associates from plan 002)	115/115
HCE	40 Partners +5 Associates+2 terminating partners +2 terminating associates	40+5 (from 002) +2+2 (from 002)	49/49=100%
NHCE	30 support +20 associates +8 terminating support +8 terminating associates	30+20 (from 002) +8+8 (from 002)	66/66=100%

RESULTS (NHCE%/HCE%)_100/100=100%_(must be ≥ 70% to pass coverage). The (k) portion of the Plan now passes.

Continued on next page

Case study-same facts, aggregating plans 001 and 002, Continued

401 (m—aggregating plans 001 and 002

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40 (Partners) +30 (Support +25 (Associates)+20 (terminating)	40+30+25+20 (25 associates from plan 002)	115/115
HCE	40 Partners +5 Associates+2 terminating partners +2 terminating associates	40+5 (from 002) +2+2 (from 002)	49/49=100%
NHCE	30 support +20 associates +8 terminating support +8 terminating associates	30+20 (from 002) +8+8 (from 002)	66/66=100%

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

	NON-EXCLUDABLE	**BENEFITING**	**% = BEN/ELIG**
TOTAL	40 (Partners) +30 (Support) +25 (Associates) +10 (terminating)	40+30	
HCE	40 Partners+5 associates + 1 terminating partner +2 terminating associates	40 partners	40/48=83%
NHCE	30 support+20 associates +3 terminating support+4 terminating associates	30	30/57=53%

RESULTS (NHCE%/HCE%) 53/83=64 (must be ≥ 70% to pass coverage). THE (P/S) PLAN STILL FAILS BECAUSE PLAN 002 DID NOT HAVE A PROFIT SHARING COMPONENT TO AGGREGATE WITH PLAN 001.

Case study—modifications to the profit sharing plan

Introduction

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.

	NON-EXCLUDABLE	BENEFITING	% = BEN/ELIG
TOTAL	40 partners + 28 support + 12 associates + 10 terminating	40+28	68/90
HCE	40 partners + 2 associates + 1 terminating partner + 2 terminating associates	40	40/45=88%
NHCE	28 support + 10 associates + 3 terminating support + 4 terminating associates	28	28/45=62%

RESULTS (NHCE%/HCE%) 62/88=70% (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.

Examination steps-coverage-G-09

Inspect the plan document

Inspect the plan document, reviewing the sections concerning eligibility.

> An employer may have separate eligibility requirements for elective contributions, matching contributions and discretionary contributions.

Review plan sections that define eligible employees and all plan sections that specify age and service requirements and entry dates, keeping in mind that a CODA cannot require that an employee complete more than 1 year of service in order to be eligible to make elective contributions.

Review the following records-introduction

When testing the plan for coverage, the following records should be reviewed to determine proper inclusion or exclusion of employees (including records for any related entities of controlled groups or affiliated service groups).

Inspect 5500 and compare with employee's payroll records

Inspect the Form 5500 series return and extract:

- the total number of employees of the employer,
- employees excluded and
- employees benefiting.

Compare these numbers with the numbers from the employer's payroll records to determine if all employees have been accounted for on the return.

Determining testing options being used

Determine the testing option being used by the plan. For the 401(k) and/or (m) disaggregated portion of the plan, Regs 1.410(b)-8 indicates the Annual testing option must be used for coverage, unless a snapshot day that meets Rev Proc 93-42 Section 3 is used. The profit sharing portion of the plan may be tested using any of the testing options in the Regs and snapshot testing.

Determine whether the plan is being tested on a QSLOB basis. Form 5310- been filed in accordance with Rev Proc 93-40. In addition Schedule T Form 55 information on QSLOBs and coverage testing.

These above options determine the population of employees that must be looked at to determine eligibility and benefiting status.

Continued on next page

Examination steps-coverage-G-09, Continued

Determine whether plan uses 3 year testing cycle

Determine whether the plan uses the three-year testing cycle under Rev Proc 93-42 section 5 for coverage. If three year testing cycle is used, then data from years **not under examination** may need to be reviewed to determine if coverage is satisfied.

Inspect payroll records

Inspect employer payroll records to extract the total employees, birth dates, hire dates, hours worked, union status and other pertinent information.

Inspect payroll records and extract the names of those employees who terminated employment during the year.

> Many plans will require an employee to be employed on the last day of the plan year in order to receive an allocation of an employer discretionary contribution.

Any terminated employee with 500 or more hours of service must be included in the coverage test. Many small plans have a last-day requirement in their plans and can easily fail coverage because of this requirement.

If:

- snapshot quality data is being used and
- the disaggregated portion of the plan has a last-day requirement and/or a minimum service requirement,

then the adjustment in Rev Proc 93-42 section 3.05 may be necessary.

Continued on next page

Examination steps-coverage-G-09, Continued

Inspect W-2s etc.

Inspect Form(s) W-2 and State Unemployment Tax Returns (compare the employees on these records with the employer's payroll records) to ensure all employees of the employer are considered.

Inspect participant election forms

Inspect participant election forms to verify the names of eligible employees who have elected not to have elective contributions made to the plan.

> These employees are considered as eligible employees benefiting under the plan (and included in the ADP/ACP tests with a zero ADR).

These employees also must be included for other applicable purposes, such as allocation of other contributions, such as top-heavy minimums, profit sharing, etc. contributions, if they are otherwise eligible.

Inspect schedule E

Inspect Schedule E, Compensation of Officers, of Form 1120 to gather names of officers and ownership percentages to help identify any related entities.

Inspect form 851 and 1040

Inspect any Form 851, Affiliation Schedule, attached to the Corporate Income Tax return to determine if there are any related entities.

Inspect a self-employed individual's Form 1040 Income tax return to determine whether there are any other entities operated and owned by the self-employed individual. Separate Schedule Cs, Profit or Loss from Business, should be filed for each business.

Continued on next page

Examination steps-coverage-G-09, Continued

Inspect plan document for leased employees

Inspect the plan document to determine whether the plan covers leased employees.

If the employer has leased employees the plan may state that these employees are excluded, however, certain rules apply under IRC section 414(n) that may require the employer to include these leased employees for purposes of certain code sections, such as coverage and discrimination.

Obtain contracts of the employer with any leasing organization and information/records for pension benefits received by the leased employee under the leasing organization's retirement plans.

Ensure the plan passes ratio percentage or average benefits

Ensure the plan passes either the ratio percentage test or the average benefits test under IRC section 410(b).

For purposes of the coverage test all employees of the employer must be considered, including all employees of entities that are part of a controlled group of corporations or affiliated service group that includes the employer.

- See IRC section 1563(a) and the regulations thereunder for rules on aggregation of stock ownership for controlled group rules.
- See IRC section 414(m) and the regulations thereunder for rules pertaining to affiliated service groups. There are three common forms of controlled groups: parent-subsidiary, brother-sister and combined groups.

When looking at disaggregated portions of the plan

When determining whether the disaggregated portions of the plan pass coverage, each disaggregated portion separately satisfy coverage

Make sure the determination of HCEs and NHCEs, are proper for the testing year for all of the disaggregated portions. This was covered previously in the text.

Continued on next page

Examination steps-coverage-G-09, Continued

When disaggregated portion uses average benefits test

When a disaggregated portion of the plan uses the average benefits test to pass c verify that the testing methodology satisfies Regs 1.410(b) and 1.401(a)(4). Inf similar to a Demo 5 from a determination application Schedule Q for the testing be a starting point.

Verify the underlying data used in the test.

Verify the payroll data, employment records and allocations used. The information needed will depend on the methodology used for the test.

Ensure the plan includes leased employees

Ensure the plan includes leased employees if defined as eligible under the terms of the plan.

Insure that the plan passes coverage when leased employees are required to be included in the coverage test. Generally, the employer will have to include a leased employee in the test when the leased employee is performing services on a substantially full-time basis and when the total number of leased employees constitutes more than 20% of the NHCE workforce of the employer.

> In these instances, these employees must be considered for the code sections noted under IRC section 414(n). However, an employer may include the benefits that the leased employee received from the leasing organization as being provided by the employer when testing for coverage. Therefore, it is important that extensive information is gathered when an employer has leased employees.

ADP Test-G-010

Verify ADP Test—G-010

Overall audit step

- Verify that the ADP test was performed properly.
- Determine whether the plan used Current or Prior year testing.

  If the methodology was changed from **prior to current year testing**, verify that the plan was amended to reflect that change.

  If the methodology was changed from **current to prior year testing**, determine whether the change was permitted. (See Notice 98-1 for a discussion of the change in testing methods.) Note: If the amendment was made as part of GUST, then this change would be permitted.

Overview of ADP test-G-10

Introduction

Under IRC section 401(k)(3), an employer maintaining a section 401(k) plan must annually compare the elective contributions of eligible HCEs with those made by eligible NHCEs.

If certain limits are exceeded by the HCEs, the employer must take corrective action to bring the plan within the limits.

ADP test is the exclusive nondiscrimination test for 401k plans

This testing for nondiscrimination (the ADP test) is the exclusive nondiscrimination test for amounts contributed to a CODA. Thus, the ADP test is used instead of any amounts test under IRC section 401(a)(4).

Any QNECs or QMACs treated as elective contributions must be included in the ADP test.

Two alternatives to ADP-Simple and safe harbor

The ADP test and its correction mechanisms can be costly for employers, so Congress enacted two alternatives to the ADP test:

a) For plan years beginning after December 31, 1996, employers could adopt SIMPLE 401(k) provision, modeled after SIMPLE IRAs described in IRC section 408(p). See IRC sections 401(k)(11) and 401(m)(10). Workpaper G08 addresses SIMPLE 401(k) Plans.
b) For plan years beginning after December 31, 1998, employers could adopt safe harbor 401(k) plans described in IRC sections 401(k)(12) and 401(m)(11). Workpaper G07 addresses Safe Harbor 401(k) Plans

CODA must still satisfy benefits, rights and features

Although a CODA must satisfy the ADP test (or be deemed to satisfy the ADP test as in the cases of SIMPLE and Safe Harbor 401(k) plans) with respect to the amount of elective contributions, the right to make each level of elective contributions under a CODA is a benefit, right or feature. Thus, each level that must satisfy the nondiscriminatory availability requirement of Regs. 1.401(a)(4)-4(e)(3).

Continued on next page

Overview of ADP test-G-10, Continued

Multiple use test (before EGTRRA??)

In addition to the ADP test, if an employer has one or more HCEs who are eligible under both:

- a CODA of the employer that is subject to the ADP test and
- a plan of the employer that is subject to the ACP test,

then the employer may need to perform an additional nondiscrimination test, the Multiple Use of Alternative Limitation Test.

This test is often referred to as the "multiple use test" and was designed to limit the multiple use of the "2 plus or 2 times" prong, the alternative limitation.

> Of course, if the alternative limitation is not used twice (or more), then the multiple use test need not be performed.

Employer must maintain adequate records for ADP test

The employer is required to maintain records necessary to demonstrate compliance with the CODA nondiscrimination requirements, including the extent to which QNECs and QMACs are taken into account.

ADP test requirements—G-010

Mathematical two prong test

Under the ADP test, set forth at IRC section 401(k)(3)(A)(ii), the ADP of the eligible HCEs cannot exceed the greater of:

a) 1.25 × the ADP of the eligible NHCEs, or

b) the lesser of 2 + the ADP of the eligible NHCEs or 2 X the ADP of the eligible NHCEs.

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ADP test requirements—G-010, Continued

Defining ADP and ADR

The **ADP** for a group (either HCE or NHCE) is the average of the individual ADRs of the particular group.

An eligible employee's **ADR** is the sum of that employee's elective contributions, and QNECs and QMACs treated as elective contributions, divided by the employee's compensation.

Compensation used to calculate ADR

The compensation used to calculate ADRs is limited to the IRC section 401(a)(17) amount and must also satisfy IRC section 414(s).

Thus, the definition of compensation used by the CODA must be nondiscriminatory, and elective deferrals may be included or excluded from the definition.

ADRs and ADPs expressed as a percent

The ADRs and ADPs are expressed as a percentage, rounded to the nearest one-hundredth of a percent.

If HCEs or NHCEs are the only eligible employees

If the only eligible employees under the CODA are HCEs, the plan automatically passes the ADP test.

Conversely, if the only eligible employees under the CODA are NHCEs, there is no need to run the ADP test, as there is no group, namely HCEs, to discriminate in favor of.

ADP test counts only eligible employees—defining eligibility

Only "eligible employees" are included in the ADP test.

An eligible employee is one who is eligible under the plan to make an elective contribution, **whether or not the employee actually makes any deferrals**.

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ADP test requirements—G-010, Continued

An eligible employee with no Elective deferrals is counted as a 0

If an eligible employee chooses not to make elective contributions, and no QNECs or QMACs are made under the CODA, the employee must be included in the ADP test with an ADR of zero.

Other employees who may be considered eligible

Eligible employee also includes an employee who:

a) must perform purely ministerial or mechanical acts in order to make an elective contribution,

b) chooses not to make any mandatory after-tax employee contributions in a plan requiring after-tax contributions as a prerequisite to CODA participation,

c) has been suspended from making elective contributions under the plan (e.g., for having taken a hardship distribution), or

d) may not receive additional contributions because of the limits imposed by IRC section 415(c) (and IRC section 415(e) for limitation years before 2000).

One time irrevocable election

An employee who cannot make elective contributions because he or she was:

- given a one-time irrevocable election when the employee commenced employment with the employer, or
- upon first becoming eligible under any CODA of the employer, and elected not to be eligible to make elective contributions under any plan of the employer (including any future plans that may be adopted by the employer) for the duration of his or her employment with the employer

is not an eligible employee.

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ADP test requirements—G-010, Continued

ADP tested on a "plan" basis

The ADP test is performed on the plan level, so identification of the "plan" is the first step to be performed.

> See the discussion above in Workpaper G09, CODA Coverage, regarding aggregation and disaggregation of plans.

If a plan is disaggregated into separate plans for purposes of IRC section 410(b), the CODA must also be disaggregated. Each disaggregated portion of the CODA is treated as a separate plan, and as such, subject to separate ADP testing.

If HCE in more than one CODA, combine all elective deferrals

If an HCE participates in more than one CODA maintained by the same employer, the HCE's elective contributions under all of the employer's CODAs **must be combined** to determine the HCE's ADR. This combination ADR is then used in the ADP test under each CODA.

Example of disaggregation

A plan covers all employees of the employer, but, for testing purposes, the plan is disaggregated into two plans: one covering employees with less than 1 year of service and have not attained age 21 and another covering all other employees.

The employer would run two ADP tests, one for the employees with less than 1 year of service and are under the age of 21, and the other for all other employees.

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ADP test requirements—G-010, Continued

Early participation rules-for plans that include employees not meeting age and/or service

Section 1459 of SBJPA added section 401(k)(3)(F) and section 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.

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 1 year of service and reached age 21.

> However, the plan must separately satisfy the minimum coverage rules of IRC section 410(b) taking into account only those employees who have not completed 1 year of service or are under age 21.

A single ADP test is applied that compares the ADP for all eligible HCEs 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.

Safe Harbor 401(k) plans cannot use these early participation rules.

Example illustrating early participation rule

In the case of the plan described in the above example, as an alternative to running two ADP tests, the employer elects to apply the early participation rules.

Only one ADP test is run, disregarding all NHCEs with less than 1 year of service as well as those below age 21. (Note: all eligible HCEs must be included in the ADP test.)

However, the coverage requirements of IRC section 410(b) must be satisfied for all eligible employees (both HCEs and NHCEs) who have not completed 1 year of service or who have not attained age 21.

> A plan should not be a problem with this requirement since the special definition of benefiting would include all employees eligible to make an elective deferral.

Excess contributions-G-010

Introduction

Contributions on behalf of HCEs that exceed the limits imposed by the ADP test are called excess contributions. 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.

A plan must dispose of excess contributions by:

- distributing them to certain HCEs or
- recharacterizing them as employee after-tax contributions.

QNECs and QMACs contributed on behalf of NHCEs can be used to raise the NHCE ADP, thereby reducing or eliminating HCE contributions that might otherwise become excess contributions. See the discussion under Workpaper G11 for more details.

ADP Testing Methods-G-010

Introduction

Prior to 1997, the HCE ADP for the a plan year was compared to the NHCE ADP for the same plan year (the "testing year").

For plan years beginning after December 31, 1996, a plan can choose, by specifying in the plan document, to perform the ADP test:

- by comparing the HCE ADP with the same year's NHCE ADP ("current year testing") or
- by comparing the HCE ADP for a testing year with the prior plan year's NHCE ADP ("prior year testing").

Current year testing-ADP Test-G-010

Introduction

Elective contributions of an employee are taken into account for a plan year in current year ADP testing only if they are

- allocated to the employee's account as of a date within that plan year and
- paid to the trust no later than 12 months after the end of the plan year to which the contributions relate.

DOL regulations require elective deferrals be contributed much earlier

The Department of Labor regulations require that elective contributions must be paid into the trust by the earliest date such contributions can reasonably be segregated from the employer's general assets. See DOL Regs. 2510.3-102.

Elective contributions must relate to specific compensation

Further, the contributions must relate to compensation that, but for the employee's election to defer, would have been received by the employee:

- in the plan year, or
- within 2½ months after the plan year

if the compensation is attributable to services performed in the plan year.

Note--this is the rationale for Rev. Rul. 90-105, 2002-46 and Notice 2002-48, which prevent employers from taking a deduction for elective contributions that are attributable to services rendered after the end of the plan year.

Disadvantage to current year testing

In current year testing, the employer may not know for certain how much HCEs can defer for a particular plan year until the plan year is over, and by then it may be too late to have prevented excess contributions from arising. In calendar-year section 401(k) plans, the ADP test is usually performed around the end of January when the plan administrator receives all the necessary demographic and financial information.

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Current year testing-ADP Test-G-010, Continued

QNECs and QMACs can be taken into account

Under IRC section 401(k)(3)(D), an employer may take into account QNECs and QMACs in calculating the ADP.

However, the regulations require that such QNEC and QMAC contributions must satisfy:

- the nonforfeitability (100% vesting) requirement,
- the distribution limitations and
- the 12-month contribution-to-the-trust rule that apply to elective contributions.

Additional requirements for QNECs and QMACs

In addition, QNECs, both before and after some or all are used in the ADP test, must satisfy IRC section 401(a)(4).

Note that QNECs and QMACs made after the tax return filing date are not deductible for the prior taxable year. These contributions are counted, with other employer contributions, against the IRC section 404 deduction limits for the year the contributions are made.

QNECs or QMACs that are used in the ACP test cannot be used in the ADP test.

Example illustrating current year testing

Employer X maintains a plan containing a qualified CODA that provides that distribution of excess contributions is the only method under the plan to correct ADP test failures.

The plan has a calendar year plan year and both HCEs and NHCEs make elective contributions to the plan.

In January 1997, Employer X determines that the plan fails the ADP test for 1996, and that a corrective distribution of excess contributions must be made to appropriate HCEs by March 15, 1997, to avoid all penalties.

Prior year testing-ADP test-G-010

Introduction-advantages to prior year testing

Generally, the rules that apply to calculating ADRs and ADPs in current year testing also apply to prior year testing.

Prior year testing simplifies plan administration because an employer can determine the percentage of elective contributions that can be made on behalf of HCEs early in the plan year and have more time to plan for correction.

Eligible employees in determining prior year testing

The eligible employees taken into account in determining the prior year's ADP for NHCEs are those eligible employees who were NHCEs during the preceding year, without regard to the employee's status in the testing 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 for NHCEs for the preceding plan year is deemed to be 3 percent. However, an election can be made to use the actual ADP data for the first plan year.

Example illustrating prior year method

The facts are the same as in the above example under Current Year Testing, except that the testing year is 1997 and the plan is using the prior year testing method.

The ADP for the NHCEs for 1996 under the plan can be determined early in 1997 by Employer X because it has obtained the necessary data on prior year NHCE status, contributions and compensation by January 1997.

This simplifies plan administration for Employer X.

Example illustrating prior year method

Employee A was employed by Employer X and was an NHCE in Year One. Employee A no longer works for Employer X in Year Two.

For purposes of determining the prior year's ADP for Employer X's section 401(k) plan for the Year Two testing year, Employee A is taken into account.

> The result would be the same if Employee A were still employed by Employer X but had become a HCE in Year Two.

Other issues-ADP test-G-010

Plan must specify which method to use

Notice 97-2 and Notice 98-1 provide guidance on the use of the prior year method and the current year testing method and on changing from one method to the other. In general, Notice 98-1 requires that a plan must specify which of the two testing methods it is using. If the testing method is changed, the plan must be amended to reflect the change. See § IX of Notice 98-1.

Use of QNECs and QMACs with prior year method

To be taken into account for the NHCE ADP for the prior year, a QNEC or QMAC must be

- allocated as of a date within that prior year, and
- must actually be paid to the trust by the end of the 12-month period following the end of that prior year.

In other words, the contribution must actually be paid to the trust by the end of the testing year.

Thus, when using prior year testing, an employer cannot use QNECs or QMACs to correct a failed ADP or ACP test because the employer won't know until after the testing year whether or not the ADP or ACP test is failed. Once an employer determines the ADP/ACP test has failed, the deadline for making corrective QNECs and QMACs would have passed.

> Of course QNECs and QMACs made prior to the deadline can be counted.

Example

A plan uses the prior year testing method for the 1999 testing year. QMACs that are allocated to NHCEs' accounts as of the last day of the 1998 plan year may be taken into account in calculating the ADP only if those QMACs are actually contributed to the plan by the last day of the 1999 plan year.

The problem arises because with the 1999 testing year, the employer won't know whether the plan has failed the ADP test until sometime in 2000. The testing year ends in 1999, and the HCE ADP, which is still calculated in the current year, would be calculated sometime in January 2000. If the plan fails the ADP test at that point, the employer could not make QNECs since these contributions had to be made by the end of 1999 due to the prior year method being used for the NHCE ADP.

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Other issues-ADP test-G-010, Continued

Relationship to 415

Note that this 12-month rule does not change the rule under IRC section 415, that employer contributions shall not be deemed credited to a participant's account for a particular limitation year unless the contributions are actually made no later than 30 days after the end of the IRC section 404(a)(6) period applicable to the taxable year with or within which the particular limitation year ends. See Regs. 1.415-6(b)(7)(ii).

Thus, if QNECs are made at the end of the testing year, the annual addition for 415 purposes may be in the following limitation year.

First year rule for prior year testing

For the first plan year of a plan (other than a "successor plan," see below) that uses prior year testing, the ADP for NHCEs for the prior year is deemed to be 3%. See IRC section 401(k)(3)(E).

Alternatively, if the employer so elects in the plan document, the NHCE ADP is equal to the NHCE ADP for that first plan year (i.e., the current year).

For ADP testing purposes, the "first plan year" is the first year in which the plan provides for elective contributions. A plan does not have a first plan year if for that year it is aggregated under the regulations with any other plan that provided for elective contributions in the prior year.

A plan is a "successor plan" if 50% or more of the eligible employees for the first plan year were eligible employees under another CODA maintained by the employer in the prior year.

Change in NHCEs when using prior year testing-ADP Test, Prior year-G-010

General rule-disregard changes to NHCE

In general, under the prior year testing method, subsequent changes in the group of NHCEs are disregarded. That is, the ADP for NHCEs for the prior year is determined with respect to eligible employees who were NHCEs in that prior year, and without regard to changes in the group of eligible NHCEs in the testing year.

This is true even though:

- some NHCEs in the prior year have become HCEs in the testing year or are no longer eligible employees under the plan.
- some NHCEs in the testing year were not eligible employees in the prior year.

Change to NHCE-Exception to general rule

If a plan results from or is affected by a "plan coverage change" that becomes effective during the testing year, the NHCE ADP for the prior year is the weighted average of the ADPs for the **prior year subgroups**.

Defining a plan coverage change

A "plan coverage change" is a change in the group(s) of eligible employees on account of:

a) the establishment or amendment of a plan;
b) a plan merger, consolidation, or spinoff under IRC section 414(l);
c) a change in the way plans are (or are not) permissively aggregated under Regs. 1.410(b)-7(d); or
d) any combination of the above.

Definition of prior year sub-group

A "prior year subgroup" is all NHCEs for the prior year who were eligible employees under a specific CODA maintained by the employer, and who would have been eligible employees under the plan being tested if the plan coverage change had been effective as of the first day of the prior year.

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Change in NHCEs when using prior year testing-ADP Test, Prior year-G-010, Continued

Defining weighted average

The "weighted average of the ADPs for the prior year subgroups" is the sum, for all prior year subgroups of the "adjusted ADPs."

Adjusted ADP

The "adjusted ADP" for each prior year subgroup is the ADP for the prior year for all NHCEs of the specific plan under which the members of the prior year subgroup were eligible employees, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup, and the denominator of which is the total number of NHCEs in all prior year subgroups.

Exception

An exception to the exception: If there is a plan coverage change, and 90% or more of all NHCEs from all prior year subgroups are from a single prior year subgroup, then the employer may elect to use the prior year ADP for NHCEs of the plan that included that single prior year subgroup. Notice 98-1 contains examples involving plan coverage changes.

Changing testing methods—ADP test, G-010

Changing from prior year to current year method

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.

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Changing testing methods—ADP test, G-010, Continued

Changing from current year method to prior year

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:

a) 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).

b) 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).

c) A transaction occurs that is described in IRC section 410(b)(6)(C)(i) (i.e., the employer becomes or ceases to be a member of an IRC 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 IRC section 410(b)(6)(C)(ii) (i.e., by the last day of the 1st plan year beginning after the transaction).

d) 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).

Double counting-ADP test, G-010

Introduction-description of issue--when change from current to prior year

When a plan changes from current year testing to prior year testing, contributions on behalf of many, if not all, NHCEs are likely to be double counted.

For example, if a plan used current year testing in 1998, and then changed to prior year testing in 1999, elective contributions on behalf of NHCEs for 1998 will be counted twice:

- once in 1998 in calculating the NHCE ADP under the current year testing method, and
- again in 1999 in calculating the NHCE ADP under the prior year testing method.

Rules limiting double counting

To limit double counting, Notice 98-1 provides that the ADP for NHCEs for the prior year is determined taking into account only:

a) elective contributions for NHCEs that were taken into account for purposes of the ADP test (and not the ACP test) under the current year testing method in the prior year; and

b) QNECs that were allocated to NHCEs' accounts for the prior year, but that were not used to satisfy either the ADP test or the ACP test under the current year testing method for the prior year.

Contributions disregarded

Thus, the following contributions made for the prior year are disregarded for the ADP test:

- QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior year,
- elective contributions taken into account for purposes of the ACP test, and all QMACs.

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Double counting-ADP test, G-010, Continued

Effective date for double counting

These limitations on double counting do not apply for testing years beginning before January 1, 1999. Thus, for a plan that changes to prior year testing for the first time for the 1998 plan year, the ADP and ACP for NHCEs will be the same as for the 1997 plan year. See Notice 98-1 for examples involving double counting.

The items a plan must provide with respect to testing method, ADP test, G-010

Plan must specify testing method

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.

Incorporation by reference

The regulations under IRC section 401(k) and (m) permit a plan to incorporate by reference IRC section 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) it 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

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The items a plan must provide with respect to testing method, ADP test, G-010, Continued

Remedial amendment period

Rev. Proc. 2001-55 extends the remedial amendment period for GUST generally to the last day of the first plan year beginning on or after February 28, 2002.

Any plan amendments to reflect a choice in testing method do not have to be adopted before the end of this remedial amendment period. However, plans must be operated in accordance with the GUST changes as of the statutory effective date (section 1433(c) and (d) of SBJPA, 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. This includes the choice of testing method (and any changes to that method), and must reflect the date(s) on which the plan began to operate in accordance with those choices (and any changes).

Examination Steps – ADP Test

Review plan language

Review the plan language to identify eligibility requirements and ensure that the plan is operating in accordance with the plan document.

Review financial plan audit reports

Review financial plan audit reports and corporate minutes for comments relating to:

- eligibility provisions, and
- ADP testing and correction

Administrator should explain policies

Have the plan administrator explain policy/procedures for ADP/ACP/402(g) testing (including correction). Analyze the testing methodology and results confirming the accuracy of each ADP test.

Continued on next page

Examination Steps – ADP Test, Continued

Review safe harbor plan language

If the plan used a safe harbor method to satisfy the ADP/ACP tests, review the plan language and verify the employer made matching contributions or nonelective contribution that satisfied the safe harbor requirements.

Also verify that the notice requirements were met.

Establish eligible employees are counted for ADP test

Establish that all employees who are eligible under the plan to make elective contributions are counted in the ADP test, even if some do not make elective contributions.

a) Check the overall group of eligible employees to determine whether those who have satisfied the plan's age and service are allowed to make deferrals. Also ask if any other benefits are contingent on a contribution into the CODA.

b) Determine whether employees who are eligible to make a deferral but cannot because they have been suspended from making deferrals (e.g. because of receiving a hardship distribution), and who are allocated no QNECs or QMACs that are treated as elective contributions, have been included as "eligible" with a deferral percentage of "0" when running the ADP test.

Compare actual eligible with number of employees used to run ADP test

Compare the total number or eligible employees (including those who would be eligible but for a plan provision requiring a ministerial or mechanical act) with the number of employees used to run the ADP test. They should be the same.

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Examination Steps – ADP Test, Continued

Verify compensation-inspect payroll records etc

Examine payroll records, Forms W-2, time cards and personnel records, to verify employee compensation.

If the plan year is not a calendar year, review the plan document to determine which period should be used and verify the operation of those provisions.

If the employer limits compensation to the portion of the year in which the employee was eligible, verify that the plan's terms allow for such limitation and examine employees with such limited compensation.

If limited, the amount of compensation should be that earned since participation in the plan.

Verify 401(a)(17) limits

Verify that all compensation figures are limited in accordance with IRC section 401(a)(17). If the plan is not a safe harbor plan, examine the ADP test to verify that each individual's ADR is calculated using the properly limited compensation.

Compensation used in the ADP test can **either** include or exclude elective contributions deferred during the year. The definition of compensation in Reg. 1.414(s)-1 makes reference to IRC section 415(c)(3), which includes elective deferrals in compensation (IRC section 415(c)(3)(D)).

However, Reg. 1.414(s)-1(c)(3) contains a safe harbor alternative definition of compensation that satisfies IRC section 414(s) and does not count deferred compensation.

Compare 5500 with ADP test

Reconcile the total participant deferral contributions shown on Form 5500, Schedule H or I, to the total deferral amount shown on the ADP test.

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Examination Steps – ADP Test, Continued

Determine whether HCEs properly determined

Test check whether the highly compensated employee group was properly determined, using payroll and organization data.

Verify that an employee was considered an HCE if:

- he or she was a 5% owner during the year or preceding year, or
- had compensation above $80,000 (indexed) for the preceding year, and if the employer so elected, was in the top-paid group that year.

If plan disaggregated, ADP test should be run for each disaggregated plan

If a plan is disaggregated under IRC section 410(b), make sure that the ADP test is also run **separately** on each disaggregated plan.

Apply the aggregation and disaggregation rules of Reg. 1.410(b)-7, as modified by Reg. 1.401(k)-1(g)(11), to find the "plan" (or plans) so that the ADP and ACP tests (or safe harbor or SIMPLE rules) can be applied to the proper employees.

Ensure only plans with the same PYE are aggregated, if otherwise permitted.

Review plan documents for eligibility

Review the plan document to determine the eligibility requirements for the CODA.

If the eligibility requirements are less than 1 year of service and/or less than age 21, the nondiscrimination testing may be applied on a disaggregation basis.

Separate tests may be run; one for employees with less than 1 year of service and less than age 21, and one for all other employees.

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Examination Steps – ADP Test, Continued

Special rule-eligibility-can disregard certain NHCEs

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 is required to separately satisfy the minimum coverage rules of § 410(b) by taking into account only those employees who have not completed one year of service or are under age 21.

A **single ADP test** is applied that compares the ADP for all eligible HCEs 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.

Disaggregate if plan is an ESOP

If the plan is an ESOP, the ESOP portion of the plan must be disaggregated from the CODA in the same plan.

This is true even if any HCE participates in the CODA portion of the ESOP and a CODA of another plan maintained by the employer.

Determine if employees are under a collectively bargained agreement

Determine if any employees of the employer are covered by a collective bargaining agreement. If so, these employees must be disaggregated from employees not covered by a collective bargaining agreement for purposes of the ADP test.

Review any lists, which identify employees covered by a collective bargaining agreement, such as reports prepared for payment of union dues or payroll records showing union dues deductions. Compare these employees to the separate ADP testing for employees under the collective bargaining agreement.

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Examination Steps – ADP Test, Continued

Review 5500s to determine if any other plans are maintained by employer

While inspecting the 5500 returns for all plans, determine if any other plan maintained by the employer contains a CODA. If so, the plans may be aggregated for purposes of the ADP testing, but only if they have the same plan year.

If two or more plans are aggregated for the ADP test, they must also be aggregated for coverage and discrimination testing. Inquire of the employer which plans were aggregated, if any.

Verify from payroll records whether employees counted for the coverage and discrimination testing are the same employees in the ADP test if the plans were aggregated.

Determine if HCEs are in more than one plan

Determine if any HCE is participating in more than one plan, which contains a CODA. If yes, the elective contributions for each HCE must be combined for purposes of determining ADRs. This ADR is then used in the ADP test for all CODAs.

Compare ADP calculations to compensation and deferrals

Compare ADP calculations to compensation and deferral amounts shown on Forms W-2 (or payroll records if the plan year is a fiscal year). Trace the individual entries to source documents.

Verify ADP test

Verify that the ADP test for each group (HCE and NHCE) has been properly determined and that the ADP test was satisfied in accordance with the plan provisions describing the testing method (current year or prior year).

If plan failed the ADP test—G-11

Overall audit step

Verify that excess contributions were properly identified by using the appropriate leveling method. Verify that ADP correction was made properly and in accordance with the plan document. If correction was not timely, verify that Form 5330 was filed to report and pay IRC 4979 taxes due, and Form(s) 1099 were filed to report corrective distributions or recharacterizations.

Determination of excess contributions

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

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If plan failed the ADP test—G-11, Continued

Example-determining excess contributions

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

- HCE 1 has compensation of $80,000 and elective contributions of $8,800 for an ADR of 11%;
- HCE 2 has compensation of $100,000 and elective contributions of $9,000 for an ADR of 9%; and
- HCE 3 has compensation of $150,000 and elective contributions of $10,500 for an ADR of 7%.

The HCE ADP is 9%.

Assume 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 in order to produce a HCE ADP of 8%. The percentage leveling method is used to reduce the HCE percentages.

Start with the highest ADR, which is HCE 1's 11%. This percentage is reduced to the next highest, HCE 2's 9%, and then both HCE 1 and HCE 2's reduced ADRs are further reduced to 8.5%, so that the HCE ADP using these reduced ADRs is 8%.

- HCE 1's ADR reduction by 2.5% produces excess contributions of $2,000 (2.5% x $80,000) and
- HCE 2's ADR reduction by 0.5% produces excess contributions of $500 (0.5% x $100,000) .

The total amount of excess contributions is $2,500.

Distribution of excess contributions-G-11

Distribution of excess contributions

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

Example-distribution of excess contributions using percentage.

In the previous example, $2,000 (adjusted for earnings) would be distributed to HCE1 and $500 (adjusted for earnings) to HCE2 if distributing based on the HCEs who had the excesses.

Note that HCE 1 had the highest excess, and that by distributing the $2,000, HCE's ADR would be reduced from 11% to 8.5%.

HCE 2 would receive a distribution of $500, and the ADR would be reduced from 9% to 8.5%.

Change in distribution rules—use highest dollar contributions

Section 1433(e) of SBJPA amended IRC sections 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 are distributed to HCEs who have the largest amount of contributions in the numerator of their ADR (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.

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Distribution of excess contributions-G-11, Continued

Example illustrating dollar method

In the previous example, the $2,500 of excess contributions would be allocated $1,900 to HCE 3 (the HCE with the largest amount of elective contributions), $400 to HCE 2 (the HCE with the next largest amount of elective contributions) and $200 to HCE 1. Note, the "dollar leveling method", HCE 3 gets back $1,500, reducing HCE 3's elective contribution from $10,500 to $9,000.

The next reduction is both HCE 2 and HCE 3, from $9,000 to $8,800, which is another $400. So far, $1,900 has been distributed ($1,500 and then $400).

For the remaining $600, each HCE receives $200. Thus, as totals:

- HCE 3 receives $1,900 ($1,500+$200+$200)
- HCE 2 receives $400 ($200+$200) and
- HCE 3 receives $200.

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.

> As explained above, the ADP test would be satisfied by distributing the excess contribution to the participants with the highest ADR percentage—using the leveling method. If the distributions are not made to those employees, the actual ADRs will be different, resulting in a different HCE ADP.

See Notice 97-2

See Notice 97-2 for a more detailed example involving corrective distributions.

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Distribution of excess contributions-G-11, Continued

Distribution of earning on the excess contributions

A plan must distribute both the excess contribution and the earnings attributable to the excess contribution. Any reasonable method of determining income or loss otherwise used by the plan may be used to determine income or loss attributable to excess contributions. The regulations do not require the plan to determine or pay out the ‘‘gap period’’ earnings (i.e., the earnings for the period from the end of the plan year to the distribution date).

However, if a plan does provide for distribution of gap period earnings, the method used must be consistent for all participants and must be either the method the plan normally uses to allocate income to participants' accounts or the safe harbor method provided in the regulations.

When distributions have to be made

A failed ADP test can be corrected by distributing excess contributions, adjusted for earnings, to certain HCEs **by no later than 12 months after the close of the testing year**, regardless of whether the plan is using the prior year or current year testing method.

Multiple use test is applied after correction

Notice 97-2 provides that after excess contributions and excess aggregate contributions, if any have been distributed using the method described above, the multiple use test of section 401(m)(9) is applied.

For purposes of section 401(m)(9), if a corrective distribution of excess contributions has been made, or a recharacterization has occurred, the ADP for HCEs is deemed to be the largest amount permitted under section 401(k)(3).

Similarly, if a corrective distribution of excess aggregate contributions has been made, the ACP for HCEs is deemed to be the largest amount permitted under section 401(m)(2).

Excess contributions reduced by excess deferrals under 402(g)

Excess contributions distributable to a HCE for a plan year are reduced by the amount of any excess deferrals (amounts over the IRC section 402(g) limit) that have been distributed to the HCE for the HCE's tax year that ends with or within the plan year.

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Distribution of excess contributions-G-11, Continued

Reporting the excess contributions

Distributions of excess contributions plus earnings must be reported on Form 1099–R using the appropriate code.

> Such distributions are taxable distributions under IRC section 72, but are not subject to the consent rules under IRC sections 411(a)(11) and 417 or the early withdrawal tax under IRC section 72(t).

The distributions must be immediately subject to income tax, so a ‘‘distribution’’ of the excess contributions into a nonqualified deferred compensation arrangement is not a permissible method of correction.

If distributions are made within the first 2 ½ months

If the distributions are made within the first 2½ months following the end of the plan year, the distributed amounts are treated (for income tax purposes) as if received by the employee as of the earliest date the employee could have received the amount in cash.

> In most cases, this means the distributions will be taxable in the preceding calendar year.

If the distributions are made after the first 2½ months, the distributions are taxable in the year distributed (and the employer is subject to the 10% tax under IRC section 4979 tax).

> However, under IRC section 4979(f)(2)(B), if the total excess contributions and any excess aggregate contributions are less than $100 (without regard to attributable earnings), the amount is included in gross income in the year distributed even if the distribution is made in the 2½ month period.

Correction ADP—Recharacterization of Excess Contributions-G-11

Introduction

Under IRC section 401(k)(8)(A)(ii), a CODA can correct an excess contribution by "recharacterizing" an employee's excess contributions as an employee after-tax contribution. This is a fiction in which **the plan is deemed to have distributed the excess contribution and the HCE is deemed to have contributed this amount to the plan as an after-tax employee contribution.**

The total amount of excess contributions and the HCEs to whom they are allocated is determined in the same manner as for distributions of excess contributions, except the amount recharacterized does not include earnings.

Can recharacterize only in first 2 ½ months

Plans may only recharacterize excess contributions within the first 2½ months after the plan year during which the excess arose, and then only if the plan otherwise allows for employee after-tax contributions.

Notification to HCE required to recharacterize

The employer or plan administrator must notify the HCEs to whom the excess contributions are allocated that the excess contributions are being recharacterized and must inform them of the tax consequences of the recharacterization.

The date of the recharacterization (used to determine whether the 2½-month rule has been satisfied) is the date on which the last affected HCE receives notification. Thus, there is no "physical movement" of any funds, just the notification to the HCEs of the tax consequences.

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Correction ADP—Recharacterization of Excess Contributions-G-11, Continued

Reporting recharacterizations	Excess contributions that are recharacterized are reported and appropriately coded on Form1099-R and are included in gross income according to the same rules that apply for actual distributions of excess contributions.
Recharacterizations are employee contributions subject to ACP test	Once an amount has been recharacterized, it will be considered an employee contribution subject to the ACP test. However, for all other qualification purposes, such as deductibility under IRC section 404, the recharacterized amount continues to be considered an employer contribution.
Plan may require recharacterization or allow employee to choose	The plan may require recharacterization of excess contributions or may allow affected HCEs to choose between recharacterization and distribution.

Section 4979 tax—ADP test failure-G-11

Introduction

IRC section 4979 imposes a tax on the employer equal to 10% of any excess contributions not corrected within 2½ months after the end of the plan year to which they relate.

> However, the tax **does not apply** if corrective QNECs or QMACs (current year testing plans only) are made within 12 months after the end of the plan year.

If the QNECs or QMACs were insufficient to fully satisfy the ADP test, the tax will apply to the remaining excess contributions.

Plan has 12 months to correct, but only 2 ½ months to avoid tax

The plan has 12 months after the end of the plan year being tested to correct excess contributions. The plan can distribute excess contributions any time during the 12-month period, but the employer will still be subject to the 10% tax if the **distribution** is made after the 2½-month period.

Again, if QNECs or QMACs are made within 12 months after the testing year, then the tax does not apply, even if distributions are not made after 2 ½ months after the testing year.

Reporting 4979 tax on 5330 and is a one time tax

The tax is reported on Form 5330 and is due 15 months after the end of the plan year. See Reg. 54.4979–1. Any extension of time to pay the tax is not an extension of time to correct the ADP test.

The tax is a one-time tax, meaning, if excess contributions are not timely corrected for a plan year, the tax applies only for that year.

Exam steps—failed ADP test—G-11

ADP test failures

For ADP test failures, verify proper and timely correction. Consider:

a. Whether the correction method was specified in the plan document and whether the method was followed; and
b. Whether the amount of excess contributions was calculated using the correct leveling procedure.

Correction by distribution, inspect cancelled checks, 1099s and form 5330s

a. Inspect cancelled checks or trust statements to determine the date of distribution of the excess contributions (plus attributable earnings).

b. Inspect Form(s) 1099-R issued for distribution of excess contributions. Amounts distributed should include any gains or losses. For distributions made within the 2½-month period following the plan year end, the distribution is includible in income for the employee's taxable year in which the excess occurred. Distributions made to an employee after 2½ months or that are less than $100 (not counting earnings) are includible in income for the employee's taxable year in which the distribution was made.

c. If the distribution was made after 2½ months following the end of the plan year in which the excess arose, the IRC section 4979 tax applies. Inspect or solicit Form 5330 and verify remittance of the excise tax.

Correction by recharacterization

a. Recharacterization must occur within 2½ months following the end of the plan year in which the excess arose. Inspect recharacterization notices issued to HCEs. Recharacterization is "deemed" to have occurred on the date of the last notice.

b. Inspect Forms 1099-R to verify that recharacterized amounts were correctly reported. Earnings or losses on recharacterized amounts are not taxable and should not be included in the amount reported on the Form 1099-R.

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Exam steps—failed ADP test—G-11, Continued

Correction by QNEC, QMAC

If correction was by contribution of QNECs and/or QMACs, determine whether the contributions were made within 1 year after PYE by inspecting cancelled checks or trust statements. (Note that this correction method is not available for plans using the prior year testing method.)

Section 402(g) limitations-G-12

Overall audit step

Verify that the IRC 402(g) limitations were satisfied by reviewing payroll records, Forms W-2, or other source documents. Reconcile these amounts to participant account records.

If contributions exceeded the IRC 402(g) limitations, ensure proper and timely correction was made.

Contribution limitation

IRC section 402(g) provides that elective deferrals in excess of $7,000 (indexed for cost-of-living increases) for a year are

- included in the employee's gross income for the year and
- included in gross income again when distributed from the plan. See IRC section 402(g)(7).

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Section 402(g) limitations-G-12, Continued

Avoiding double income on excess deferrals

Deferrals in excess of the 402(g) limit are called "excess deferrals." To avoid double income inclusion of excess deferrals, an employee may inform an employer of the amount of excess deferrals in that employer's plan and request the return of them together with attributable earnings. (See Reg. 1.402(g)–1.)

If returned by April 15 following the year of the excess, such deferrals will **not** be included in gross income when distributed.

However, the employer is not required to honor such a request, although most plans do provide for such distributions.

If excess deferrals arose from plans of one employer

If the excess deferrals arose under plans of one employer, the employee cannot refuse a distribution. (See (3) and (4) below.)

If excess deferrals not distributed

If excess deferrals are not distributed and are not disqualifying (i.e., they are made to plans of unrelated employers), they must remain in the plan until there is a permitted distributable event.

Indeed, if the employee is young, it may be cost effective to leave the excess deferrals in the plan: double income inclusion being outweighed by maybe 30 years of tax-free earnings.

402(g) limits are measured by employee, not plan

IRC section 402(g) is applied to each employee, rather than to a plan, and for the employee's taxable year, which is nearly always the calendar year. Thus, it's possible that an employee can have deferrals to a plan equal to two times the 402(g) limit if the plan year is not the calendar year, although most are.

Continued on next page

Section 402(g) limitations-G-12, Continued

401(a)(30)—plan cannot accept excess deferrals, counting only plans from employer

IRC section 401(a)(30) provides that an employer's plan cannot accept elective contributions ("elective deferrals") from an employee in excess of the 402(g) limit, counting only plans of that employer.

> Thus, if an employee defers more than the 402(g) limit, in the aggregate, spread among one or more plans maintained by the employer group, such plans are not qualified.

Example

If an employee works for Company Y from January to June and then transfers to related Company Z for the next 6 months, his deferrals into Company Y's plan and into Company Z's plan for the calendar year are aggregated to determine whether the 402(g) limit has been exceeded.

The plans will fail qualification if they accept excess deferrals. This limit must be stated in the plan.

Distribute excess deferrals to avoid failing 401(a)(30)

To avoid failing IRC section 401(a)(30), a plan must distribute excess deferrals and related earnings by April 15 following the year of the excess. In such case, affected employees are deemed to have requested a distribution.

Excess deferrals that are timely distributed are still treated as employer contributions for most purposes of the Code, including the ADP test, but not IRC section 415. However, excess deferrals of nonhighly compensated employees that are timely distributed are not counted in the ADP test if they are prohibited by IRC section 401(a)(30). See Reg. 1.402(g)-1(e)(1)(ii).

Excess deferral distribution before April 15 reduces excess contributions

If an excess deferral is distributed before April 15, the distributing plan counts that distribution as an offset against any distribution of excess contributions that must be made to that employee to correct the ADP test.

402(g) limit only applies to elective deferrals

The 402(g) limit only applies to elective deferrals (i.e., elective contributions, in a section 401(k) plan); it does not affect other contributions that may be included in the ADP test. The amount of the 402(g) limit may be incorporated by reference.

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Section 402(g) limitations-G-12, Continued

Example

Employer A maintains a section 401(k) plan that allows participants to elect to defer up to a maximum of 15% of the their compensation for the plan year, which is a calendar year.

During calendar year 1998, Participant B elects to defer 15% of her compensation for the year. Participant B, a highly compensated employee, received compensation during the year of $100,000. The total elective contributions made on behalf of Participant B for calendar year 1998 was $15,000.

The IRC section 402(g) limit in effect for 1998 was $10,000, therefore, Participant B has an excess deferral in the amount of $5,000. Accordingly, the employer must distribute the excess, plus attributable earnings, by April 15, 1999, in order for the plan to remain qualified.

Examination Steps – IRC Section 402(g) Limits-G-11

Inspect plan document

Inspect the plan document to determine the maximum elective contributions that an employee can defer under the terms of the plan.

Inspect W-2s for 402(g) compliance

Inspect Form W-2's for purposes of testing the plan for compliance with the IRC section 402(g) limit.

Command code IRPTR with DOC CODE 21 can be used to access internal W-2 IRPTRR can be used to request a payer hardcopy, if you want all W-2s that a pa employer issued. IRPTRL can be used to request a summary for a particular pa definer code with DOC CODE 21 gives an onscreen view for all W-2's for an in taxpayer. You can page through the screens to find the appropriate W-2. To id whether an individual exceeded 402(g) with multiple unrelated employers IRPT one way.

For a plan with a fiscal year, inspect payroll records, W-2s or request IRPTRs for the calendar year. Generally, you could request payroll records for the final pay period of the calendar years that are part of the plan year and check the year to date amount of elective deferrals. Using W-2s or IRPTRs, you would look for the amount of elective deferrals or deferred compensation on the appropriate line.

The 402(g) limit is measured on the individual's tax year (calendar year) rather than the plan year.

Compare W-2 with payroll records for accuracy of reported amounts

Compare Form W-2 (Box #13 - coded "D," which indicates the amount that the individual deferred under the plan) with payroll records and account statements for reconciliation and accuracy of the deferred amounts reported.

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Examination Steps – IRC Section 402(g) Limits-G-11, Continued

Inspect all form W-2s of each entity of a controlled group

Inspect all Form W-2s of each entity of a controlled group in order to ensure the limit has not been exceeded if an employee participates in more than one section 401(k) plan of the controlled group during the year.

The IRC section 402(g) follows the individual and all deferrals must be aggregated to insure compliance with this Code section and section 401(a)(30).

> It is not unusual for an employee in a mid-size or a large company to split time between the different companies that comprise a controlled group of corporations and that may have separate 401(k) plans. In these instances, the individual cannot defer more than the 402(g) limit to the employer's plans. Thus, the deferrals must be aggregated to determine whether the limit has been exceeded.

Conduct an interview with your contact person to determine whether employees work for more than one company in the controlled group.

If get electronic media, may need a computer audit specialist

If a larger employer gives you payroll data on electronic media you may need to solicit the help of a Computer Audit Specialist (CAS). Usually the CAS can assist you in downloading the data to an Excel spreadsheet or Access Database.

The CAS can also help in conducting the testing or queries for different limitations such as IRC section 402(g). Please see Chapter ___, CPE 2003 for additional information regarding electronic audit techniques.

Ensure timely correction

After testing the section 401(k) plan for IRC sections 402(g) and 401(a)(30), it is important to ensure that any excesses were properly and timely corrected by April 15th of the following year.

Inspect Form 1099-Rs for distributions made to correct, and inspect cancelled checks to determine when the distribution was actually made.

415 limitations—G-13

Overall audit step

Verify the definition of compensation complied with IRC 415(c)(3).

Definition of compensation

A plan can use a number of definitions of compensation for determining allocations (but only to the extent the definition is stated in the plan). However, for IRC section 415 purposes, a different definition may be needed.

415 definition of compensation changed to include elective deferrals

As previously noted, for limitation years beginning after 1997, IRC section 415(c)(3) was amended to provide that the definition of compensation includes:

- elective contributions,
- IRC section 132(f)(4) elective amounts, and
- deferrals made under section 125 and section 457 plans.

Section 125 and 457 plan

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.

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415 limitations—G-13, Continued

415 compensation-1.415-2(d)(1) inclusions

The inclusions under section 1.415-2(d)(1) are:

- Wages, salaries, fees for professional services, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan to the extent that the amounts are includible in gross income (including, but not limited to, commissions paid salesman, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses, fringe benefits, and reimbursements or other expense allowances under a nonaccountable plan
- Earned income as described in section 401(c)(2)
- Amounts described in sections104(a)(3), 105(a), and 105(h), but only to the extent they are includible in gross income
- Amounts paid or reimbursed for moving expenses but only to the extent that at the time of payment it is reasonable to believe these amount are not deductible under section 217
- The value of a non-qualified stock option, but only to the extent the option is includible in gross income for the taxable year in which granted
- The amount includible in the gross income of an employee upon making the election described in section 83(b)

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415 limitations—G-13, Continued

415 compensation-Exclusions under 1.415-2(d)(1)

The exclusions under section 1.415-2(d)(1) are:

- Contributions made by the employer to a plan of deferred compensation to the extent that, before the application of the section 415 limitations to the plan, the contributions are not includible in the gross income of the employee for the taxable year in which contributed.

  In addition, employer contributions made on behalf of an employee to a simplified employee pension plan described in section 408(k) are not considered compensation for the taxable year in which contributed.

  Distributions from a plan of deferred compensation are not considered compensation for section 415 purposes, regardless of whether such amounts are includible in the gross income of the employee when distributed.

  However, any amounts received pursuant to an unfunded non-qualified plan are permitted to be considered as compensation for section 415 purposes in the year includible in gross income.

- Amounts realized from the exercise of a non-qualified stock option, or when restricted stock (or property) held by an employee becomes freely transferable or is no longer subject to a substantial risk of forfeiture – See section 83 and the regulations thereunder

- Amounts realized from the sale, exchange or other disposition of stock acquired under a qualified stock option

- Other amounts which receive special tax benefits, such as premiums for group-term life insurance (but only the extent that the premiums are not includible in the gross income of the employee) or contributions made by an employer (whether or not under a salary reduction agreement) towards the purchase of an annuity contract described in section 403(b) (whether or not the contributions are excludable from the gross income of the employee)

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415 limitations—G-13, Continued

Additional definition of compensation under section 1.415-2(d)(10) and –2(d)(11)

In addition to the above, regulation sections 1.415-2(d)(10) and (11) provide for additional definitions of compensation that are treated as satisfying IRC section 415(c)(3). These definitions are:

- A definition that includes only the first item of inclusions in the table above and excludes all the exclusions from the table

- Information required to be reported under sections 6041, 6051, and 6052. Compensation is defined as wages within the meaning of section 3401(a) and all other payments of compensation for which the employer is required to furnish a written statement under sections 6041(d), 6051(a)(3), and 6052. This definition may be modified to exclude amounts paid or reimbursed for moving expenses to the extent deductible under section 217.

  This definition is generally wages as reported on Form W-2.

- Section 3401(a) wages. Compensation is defined as wages within the meaning of section 3401(a) but determined without regard to any rules that limit the remuneration included in wages based on the nature or location of the employment or services performed.

415 regs permit distribution of elective deferrals in certain cases

Regs. 1.415–6(b)(6) was amended to provide that elective contributions that constitute excess annual additions may be distributed to an employee if the excess was due to certain errors. One permitted error is a ‘‘reasonable error in determining the amount of elective deferrals that may be made with respect to an individual under IRC section 415.’’

Of course, the plan must have such correction language in the plan document. See Rev. Proc. 92–93, 1993–2 C.B. 505, for information on the correction method.

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415 limitations—G-13, Continued

If 415 excess distributed, ADP test has to be re-run

If the plan distributes the elective contributions to correct an IRC section 415 problem, the ADP test may have to be run again for each year involved, since the amounts distributed under Regs. 1.415–6(b)(6)(iv) cannot be used in the ADP test. Thus, the ADR would have to be recalculated for the employee who had received a corrective 415 distribution of elective deferrals.

Matching contributions tied to excess 415 elective deferrals

In addition, if the elective contribution distributed is tied to a matching contribution, the remaining matching contribution may be discriminatory if the employee receiving the distribution is a HCE.

There is no mechanism for either forfeiting or distributing this discriminatory matching contribution. However, Regs. 1.401(a)(4)–11(g)(3)(vii)(B) provides a method of correcting discriminatory matching contributions (if the problem is discovered and can be corrected within 10½ months after the end of the plan year).

Examination Steps – IRC Section 415 Limits

Review form 5500 for disclosure of 415 excess	Review Form 5500, Schedule H or I, Item 2(f), for disclosure of distributions made to correct IRC section 415 excess annual additions.
Inspect corporate minutes and financial audit reports	Review plan financial audit reports and corporate minutes for comments that address section 415 concerns.
Check W-2s	Check the W-2 information for IRC section 415 excess amounts.
Determine if employer maintains more than one plan	If employer maintains more than one plan, verify that annual addition calculations reflect contributions made to all defined contribution plans and employee contributions to defined benefit plans maintained by the employer. Ensure that the elective deferrals to all IRC section 401(k) plans and similar arrangements and salary reduction contributions to cafeteria plans are included in compensation for purposes of IRC section 415 testing.
Review plan document	Review the plan document for IRC section 415 limitation language and methods of correction of excess amounts.
If there were 415 excesses	If there were IRC section 415 excesses during the year, verify that the correction method was proper and complied with the plan document. If the plan corrected an IRC section 415 problem by distributing elective contributions, determine whether the employer: • met the requirements for such correction (see Regs. 1.415-6(b)(6)), • re-ran the ADP test without the distributed amounts. Also, determine whether there were any matching contributions tied to those distributed amounts.

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Examination Steps – IRC Section 415 Limits, Continued

Check definition of compensation

Check the plan definition of compensation for allocation or elective contribution purposes.

If the definition does not satisfy IRC section 415, and the overall contribution levels or percentages are high, determine whether the 415 limits have been met using the IRC section 415 definition of compensation.

Section 416-Top heavy-G-14

Overall audit step

If the plan was top-heavy, verify that the minimum contributions satisfied the IRC 416 provisions described in Reg. 1.416-1 (M-18, M-19, M-20). (N/A for SIMPLE plans).

Overview

CODAs (but not SIMPLE 401(k) plans) are subject to the top-heavy rules in IRC section 416. If a plan containing a CODA is top-heavy, then the plan must:

a) vest contributions that are not immediately fully vested at a certain minimum rate, and
b) provide each nonkey employee who is employed on the last day of the plan year with a contribution equal to 3 percent of the employee's compensation for the entire year or, if lesser, the same percentage as the key employee with the highest percentage contribution.

Thus, if the highest percentage contribution given to a key employee was 4 percent, then nonkey employees must each receive a 3-percent contribution. But if the key employee with the highest percentage contribution got a 2-percent contribution, then nonkey employees need only be given a 2-percent contribution.

Continued on next page

Section 416-Top heavy-G-14, Continued

How elective contributions affect minimum contribution

- Elective contributions on behalf of key employees must be taken into account in determining the minimum contribution required for nonkey employees.
- Elective contributions of nonkey employees **do not** count towards satisfying the minimum contribution.

For example, assume the only contributions made to a profit-sharing plan for a year were elective contributions and all participants, keys and nonkeys, made deferrals of 2 percent.

If the plan is top heavy, the employer would have to make a 2-percent contribution to the plan for all the nonkeys. See Regs. 1.416–1, M–20.

How Non key matching and QNECs contributions affect minimum contributions

Nonkey employer matching contributions used in the ACP test (and QMACs used in the ADP test) are not counted towards satisfying the nonkey minimum contribution.

QNECs, however, whether or not used to satisfy the ADP test, can be used to satisfy the nonkey minimum contribution. See Regs. 1.416–1, M–18.

EGTRRA change--For years beginning after December 31, 2001, employer matching contributions are taken into account for purposes of satisfaction of the top-heavy minimum benefit.

If top heavy minimums provided in another plan

If it is determined that the top-heavy minimums are provided in another plan, and the eligibility requirements are not the same for both plans, then eligible participants in the section 401(k) plan may not be receiving the minimum benefit in the other plan. Thus, the eligible participants must receive a minimum benefit in the section 401(k) plan.

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Section 416-Top heavy-G-14, Continued

Example of minimum contributions to another plan with different eligibility

An employer maintains a money purchase pension plan and a profit-sharing plan with a CODA.

- The money purchase plan requires 1 year of service for eligibility and provides a contribution of 10% of compensation to all eligible participants.

- The profit sharing plan also requires 1year of service for the profit-sharing portion of the plan but requires only 3 months of service for the CODA portion.

Assume the CODA is top-heavy. The minimum contribution required depends on the allocations to key employees in the CODA plan. The employees who are eligible for the CODA portion of the plan who have not yet met the eligibility requirements of the money purchase pension plan, are entitled to a minimum top-heavy contribution in the CODA plan.

Examination Steps - Top-Heavy –G-14

Inspect plan document for vesting	Inspect the plan document to determine if the vesting schedule meets the requirements of IRC 416 and verify that the plan follows the schedule in operation.
If employer maintains more than one plan	If another plan is maintained, determine which plan provides the top-heavy minimum benefit.
Verify that all eligible non-key employees receive minimum contribution	Verify that all nonkey employees eligible to participate in the CODA who are employed on the last day of the plan year are receiving the top-heavy minimum benefit. If this benefit is provided in another plan, compare the allocation schedule to the list of eligible employees used for the ADP testing in the CODA plan. The list should include all employees who meet the eligibility requirements of the CODA including those who do not elect to contribute under the CODA. If discrepancies are noted, request a complete list of all employees employed on the last day of the plan year who met the eligibility requirements of the CODA. Inspect payroll or other employment records to verify information provided.
Verify the correct minimum contribution is being made	Verify that all eligible nonkey employees under the plan are receiving an employer contribution of at least 3% of compensation, (or the highest contribution to any key employee, if less than 3%),

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Examination Steps - Top-Heavy –G-14, Continued

QNECs and QMACs

If the employer has made QNECs for the plan year, they may be used to satisfy the top-heavy minimum contribution requirements even if they were used to satisfy the ADP test.

QMACs used to satisfy the ADP test or the ACP test may not be used to satisfy the top-heavy minimum contribution requirements.

If the QMACs are used to satisfy the top-heavy minimum, they may not be counted as a matching contribution.

Elective and matching contributions

Elective contributions of nonkey employees may not be counted to satisfy the top-heavy minimum contribution requirements. However, elective contributions made on behalf of key employees are considered for top-heavy minimum contribution purposes.

Note: For years beginning after December 31, 2001, employer matching contributions are taken into account for purposes of satisfaction of the top-heavy minimum benefit.

Cafeteria Plan issues—G-15

Overall audit step

Determine whether the employer maintained an IRC 125 Cafeteria Plan that permitted contributions to this CODA plan. If yes, verify that the cafeteria plan provided an option for a cash payment to the employee equal to the amount contributed to the CODA. Note: If the cafeteria plan does not provide for a cash option, the CODA is not qualified

Overview of cafeteria plans

IRC section 125 permits an employer to maintain a "cafeteria plan." A cafeteria plan allows an employee to select among various types of employer benefits by specifying where an employer contribution should be spent.

Cafeteria plans are permitted to offer a contribution into a qualified CODA as one of the options, but if it does, another option in the cafeteria plan must be a cash payment to the employee equal to the amount contributed to the cafeteria plan.

Examination steps

(1) Ask whether the employer has a cafeteria plan that allows a contribution to the CODA.

(2) Review the options available to the cafeteria plan participants to ensure that receiving cash is one of the listed options.

Elective deferrals timely deposited under DOL regulations-G-16

Overall audit step	Were deferrals deposited and allocated timely in accordance with DOL regulations? If not, there is a prohibited transaction. DOL VFC Program. For more information about the VFC program, please see chapter 12(b) of CPE 2003.
Timely deposit requirement	Contributions must be timely deposited in accordance with DOL regulations.
401k regulations refer to DOL when treating elective deferrals as plan assets	Section 1.401(k)-1(a)(2)(iii) provides that the extent to which elective contributions under a cash or deferred arrangement constitute plan assets for purposes of the prohibited transaction provisions of section 4975 of the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 is determined in accordance with regulations and rulings issued by the Department of Labor.
If elective deferrals not deposited timely	If the contributions are not timely, then a prohibited transaction has occurred and the agent must secure correction and determine whether to pursue the excise tax imposed by IRC 4975.

DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16

(a)-General rule

For purposes of subtitle A and parts 1 and 4 of subtitle B of title I of ERISA and section 4975 of the Internal Revenue Code only (but without any implication for and may not be relied upon to bar criminal prosecutions under 18 U.S.C. 664), the assets of the plan include amounts (other than union dues) that a participant or beneficiary pays to an employer, or amounts that a participant has withheld from his wages by an employer, for contribution to the plan as of the earliest date on which such contributions can reasonably be segregated from the employer's general assets.

(b)-maximum time period for pension plans

(1) Except as provided in paragraph (b)(2), of this section, with respect to an employee pension benefit plan as defined in section 3(2) of ERISA, in no event shall the date determined pursuant to paragraph (a) of this section occur later than:

- the 15th business day of the month following the month in which the participant contribution amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer), or

- the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

(2) With respect to a SIMPLE plan that involves SIMPLE IRAs (i.e., Simple Retirement Accounts, as described in section 408(p) of the Internal Revenue Code), in no event shall the date determined pursuant to paragraph (a) of this section occur later than the 30th calendar day following the month in which the participant contribution amounts would otherwise have been payable to the participant in cash.

Continued on next page

DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(c)-maximum period for welfare benefit plans

Maximum time period for welfare benefit plans. With respect to an employee welfare benefit plan as defined in section 3(1) of ERISA, in no event shall the date determined pursuant to paragraph (a) of this section occur later than

- 90 days from the date on which the participant contribution amounts are received by the employer (in the case of amounts that a participant or beneficiary pays to an employer) or

- the date on which such amounts would otherwise have been payable to the participant in cash (in the case of amounts withheld by an employer from a participant's wages).

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DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(d)-extension of maximum time period for pension plans

(d) Extension of maximum time period for pension plans.

(1) With respect to participant contributions received or withheld by the employer in a single month, the maximum time period provided under paragraph (b) of this section shall be extended for an additional 10 business days for an employer who –

(i) Provides a true and accurate written notice, distributed in a manner reasonably designed to reach all the plan participants within 5 business days after the end of such extension period, stating –

(A) That the employer elected to take such extension for that month;
(B) That the affected contributions have been transmitted to the plan; and
(C) With particularity, the reasons why the employer cannot reasonably segregate the participant contributions within the time period described in paragraph (b) of this section;

(ii) Prior to such extension period, obtains a performance bond or irrevocable letter of credit in favor of the plan and in an amount of not less than the total amount of participant contributions received or withheld by the employer in the previous month; and

(iii) Within 5 business days after the end of such extension period, provides a copy of the notice required under paragraph (d)(1)(i) of this section to the Secretary, along with a certification that such notice was provided to the participants and that the bond or letter of credit required under paragraph (d)(1)(ii) of this section was obtained.

Continued on next page

DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(d)-extension of maximum time period for pension plans (continued)

(2) The performance bond or irrevocable letter of credit required in paragraph (d)(1)(ii) of this section shall be guaranteed by a bank or similar institution that is supervised by the Federal government or a State government and shall remain in effect for 3 months after the month in which the extension expires.

(3) (i) An employer may not elect an extension under this paragraph (d) more than twice in any plan year unless the employer pays to the plan an amount representing interest on the participant contributions that were subject to all the extensions within such plan year.

(ii) The amount representing interest in paragraph (d)(3)(i) of this section shall be the greater of –

(A) The amount that otherwise would have been earned on the participant contributions from the date on which such contributions were paid to, or withheld by, the employer until such money is transmitted to the plan had such contributions been invested during such period in the investment alternative available under plan which had the highest rate of return; or

(B) Interest at a rate equal to the underpayment rate defined in section 6621(a)(2) of the Internal Revenue Code from the date on which such contributions were paid to, or withheld by, the employer until such money is fully restored to the plan.

(e)-definition

Definition. For purposes of this section, the term business day means any day other than a Saturday, Sunday or any day designated as a holiday by the Federal Government.

(f)-Examples—Example 1

Employer W is a small company with a small number of employees at a single payroll location. W maintains a plan under section 401(k) of the Code in which all of its employees participate. W's practice is to issue a single check to a trust that is maintained under the plan in the amount of the total withheld employee contributions within two business days of the date on which the employees are paid. In view of the relatively small number of employees and the fact that they are paid from a single location, W could reasonably be expected to transmit participant contributions to the trust within two days after the employee's wages are paid. Therefore, the assets of W's 401(k) plan include the participant contributions attributable to such pay periods as of the date two business days from the date the employee's wages are paid.

(f) Example 2

Employer X is a large national corporation which sponsors a section 401(k) plan. X has several payroll centers and uses an outside payroll processing service to pay employee wages and process deductions. Each payroll center has a different pay period. Each center maintains separate accounts on its books for purposes of accounting for that center's payroll deductions and provides the outside payroll processor the data necessary to prepare employee paychecks and process deductions. The payroll processing service has adopted a procedure under which it issues the employees' paychecks when due and deducts all payroll taxes and elective employee deductions. It deposits withheld income and employment payroll taxes within the time frame specified by 26 CFR 31.6302-1 and forwards a computer data tape representing the total payroll deductions for each employee, for a month's worth of pay periods, to a centralized location in X, within 4 days after the end of the month, where the data tape is checked for accuracy. The employer then issues a single check representing the aggregate participant contributions for the month to the plan. X has determined that this procedure, which takes up to 10 business days to complete, permits segregation of participant contributions at the earliest practicable time and avoids mistakes in the allocation of contribution amounts for each participant. Therefore, the assets of X's 401(k) plan would include the participant contributions no later than 10 business days after the end of the month.

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DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(f) Example 3 Assume the same facts as in paragraph (f)(2) of this section, except that X takes 30 days after receipt of the data tape to issue a check to the plan representing the aggregate participant contributions for the prior month. X believes that this procedure permits segregation of participant contributions at the earliest practicable time and avoids mistakes in the allocation of contribution amounts for each participant. Under paragraphs (a) and (b) of this section, the assets of the plan include the participant contributions as soon as X could reasonably be expected to segregate the contributions from its general assets, but in no event later than the 15th business day of the month following the month that a participant or beneficiary pays to an employer, or has withheld from his wages by an employer, money for contribution to the plan. The participant contributions become plan assets no later than that date.

(f) Example 4 Employer Y is a medium-sized company that maintains a self-insured contributory group health plan. Several former employees have elected, pursuant to the provisions of ERISA section 602, 29 U.S.C. 1162, to pay Y for continuation of their coverage under the plan. These checks arrive at various times during the month and are deposited in the employer's general account at bank Z. Under paragraphs (a) and (b) of this section, the assets of the plan include the former employees' payments as soon after the checks have cleared the bank as Y could reasonably be expected to segregate the payments from its general assets, but in no event later than the 90 days after a participant or beneficiary, including a former employee, pays to an employer, or has withheld from his wages by an employer, money for contribution to the plan.

(g) effective date This section is effective February 3, 1997.

Continued on next page

DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(h)-applicable date for collectively bargained plans

Applicability date for collectively bargained plans.

(1) Paragraph (b) of this section applies to collectively bargained plans no sooner than the later of –

(i) February 3, 1997; or

(ii) The first day of the plan year that begins after the expiration of the last to expire of any applicable bargaining agreement in effect on August 7, 1996.

(2) Until paragraph (b) of this section applies to a collectively bargained plan, paragraph (c) of this section shall apply to such plan as if such plan were an employee welfare benefit plan.

Continued on next page

DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(i) Optional postponement of applicability

Optional postponement of applicability.

(1) The application of paragraph (b) of this section shall be postponed for up to an additional 90 days beyond the effective date described in paragraph (g) of this section for an employer who, prior to February 3, 1997

(i) Provides a true and accurate written notice, distributed in a manner designed to reach all the plan participants before the end of February 3, 1997, stating –

(A) That the employer elected to postpone such applicability;
(B) The date that the postponement will expire; and
(C) With particularity the reasons why the employer cannot reasonably segregate the participant contributions within the time period described in paragraph (b) of this section, by February 3, 1997;

(ii) Obtains a performance bond or irrevocable letter of credit in favor of the plan and in an amount of not less than the total amount of participant contributions received or withheld by the employer in the previous 3 months;

(iii) Provides a copy of the notice required under paragraph (i)(1)(i) of this section to the Secretary, along with a certification that such notice was provided to the participants and that the bond or letter of credit required under paragraph (i)(1)(ii) of this section was obtained; and

(iv) For each month during which such postponement is in effect, provides a true and accurate written notice to the plan participants indicating the date on which the participant contributions received or withheld by the employer during such month were transmitted to the plan.

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DOL regulation—timeliness of contributions, 29 CFR 2510.3-102, G-16, Continued

(i) Optional postponement of applicability (continued)

(2) The notice required in paragraph (i)(1)(iv) of this section shall be distributed in a manner reasonably designed to reach all the plan participants within 10 days after transmission of the affected participant contributions.
(3) The bond or letter of credit required under paragraph (i)(1)(ii) shall be guaranteed by a bank or similar institution that is supervised by the Federal government or a State government and shall remain in effect for 3 months after the month in which the postponement expires.
(4) During the period of any postponement of applicability with respect to a plan under this paragraph (i), paragraph (c) of this section shall apply to such plan as if such plan were an employee welfare benefit plan.

History

HISTORY: [53 FR 17630, May 17, 1988; 61 FR 41220, 41233, Aug. 7, 1996; 62 FR 62934, 62936, Nov. 25, 1997]

NOTES: [EFFECTIVE DATE NOTE: 61 FR 41220, 41233, Aug. 7, 1996, revised this section, effective Feb. 3, 1997; 62 FR 62934, 62936, Nov. 25, 1997, revised paragraph (b), effective Nov. 25, 1997.]

Examination Steps - Timely Deposits

Review payroll records

Review payroll records to determine the timing of payments and deductions for payroll taxes.

Verify that deposits were timely made and made to trust

- Verify that deposits of elective deferrals were made to the plan on the earliest date on which such contributions can reasonably be segregated from the employer's general assets. However, in no event shall the date be later than the 15th business day of the month following the month in which such amounts would otherwise have been payable to the participant in cash.
- Verify that the deposit of elective contributions is made to the trust or to an account that is in the name of the plan.

Distributions-G-17

Overall audit step

- Verify distributions that were made were restricted in accordance with the plan document.
- Verify distributions were properly reported on Forms 1099-R.

Overview-restricted distributions

Elective contributions made to a CODA are subject to restricted distribution rules of IRC sections 401(k)(2)(B) and 401(k)(10).

In general, elective contributions cannot be distributed to participants before the earlier of

- death,
- disability,
- separation from service (severance from employment), and
- plan termination, but only if the employer does not establish a successor DC plan other than an ESOP.

Elective contributions in a profit sharing or stock bonus plan may also be distributed upon

- attainment of age 59½ or
- upon hardship of the employee.

Distribution of any contribution that could be used in the ADP test (i.e., QNECs or QMACs) must be similarly restricted.

Amounts attributable to elective contributions may not be distributed on account of any other event, such as completion of a stated period of plan participation or the lapse of a fixed number of years. These restrictions do not apply to distributions of employer profit sharing contributions, employee after-tax contributions or earnings on these amounts.

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Distributions-G-17, Continued

Same desk rule eliminated

The "same desk rule" contained in Rev. Rul. 2000-27 was eliminated by EGTRRA when the term "separation from service" was changed to "severance from employment" (see Notice 2002-4).

Restricted distributions

If an employee's elective contributions exceeded the IRC section 402(g) limit and the excess deferrals (and income) are not distributed within the time prescribed in Sec. 1.402(g)-1(e) (2) or (3), the amounts may be distributed only on account of death, disability, separation from service (severance from employment), plan termination, age 59 ½ or hardship.

Examination steps-distributions

Review plan document

Review the plan document and the provisions relating to distributions, specifically distributions of elective contributions, QNECs and QMACs, and verify that these distributions are properly restricted. Verify that if the plan provides for hardship distributions or distribution upon age 59 ½, that the plan is a profit sharing or stock bonus plan.

Inspect 5500s, financial statements etc.

(1) Inspect Form 5500 to determine if the plan made any distributions during the year.

(2) Inspect the plan's financial statements and the trust activity reports to verify distributions.

(3) Inspect participant account statements to verify if distribution included elective deferrals.

(4) Inspect distribution forms and other personnel records to determine the event that triggered the distribution.

(5) Inspect Forms 1099-R for the proper reporting of the distributions.

Continued on next page

Examination steps-distributions, Continued

If CODA was terminated

If the CODA has been terminated, determine whether the employer had another defined contribution plan in existence at the time of termination or established one in the 12 months following distribution of all the assets from the terminating plan. If so, the CODA is not qualified unless the assets are transferred to the other defined contribution plan or the 2% overlap rule is satisfied.

Hardship distributions, G-18

Overall audit step

Verify hardship distributions were limited to employee contributions and grandfathered amounts Reg. 1.401(k)-1(d)(2)(iii).

Verify employees were suspended from making deferrals for one year and were included in the ADP test. Verify that the plan prohibited the rollover of hardship distributions of elective deferrals in accordance with IRC 402(c)(4) (effective in 1999).

Overview, hardship distributions

A profit sharing or stock bonus plan may provide that elective contributions are available for distribution on account of hardship.

As a general rule, however, QNECs, QMACs and the earnings attributable to those QNECs, QMACs as well as the earnings attributable to elective contributions may not be distributed on account of hardship

Exception for QNECs, QMACs

The regulations permit an exception in the form of a grandfather rule for earnings, QNECs and QMACs accrued prior to 12/31/88, (or, if later, the end of the last plan year ending before 7/1/89).

This accrual amount is determined based on an employee's elective contributions, QNECs and QMACs on the applicable date and using this as frozen amounts that are not reduced by any losses incurred after that date.

Continued on next page

Hardship distributions, G-18, Continued

Other employer contributions not subject to restrictive hardship rules

Other employer contributions, outside the CODA, are not subject to these restrictive hardship rules.

Thus, a profit-sharing plan could have one set of rules for hardship distributions from the CODA and another, less restrictive, set of rules for other non-CODA contributions. Although most do, a CODA is not required to provide for hardship distributions at all.

Hardship requirements

To make a hardship distribution the plan must determine if an employee:

a) has an immediate and heavy financial need, and

b) a distribution from the plan, of the specified amount, is necessary to satisfy the financial need.

This determination can be made using either general hardship distribution standards or deemed hardship distribution standards, both as described in the 401(k) regulations.

The majority of section 401(k) plans, including all M & P section 401(k) plans use the deemed standards.

Determinations must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

Hardship distributions may be "grossed up" for taxes and penalties

The amount necessary to satisfy an immediate and heavy financial need of an employee may be grossed up to cover any taxes or penalties that may result from the distribution.

With hardship distributions no longer available for rollover treatment, the amount need not be grossed up for required withholding. Hardship distributions, however, made prior to age 59 ½ are subject to the 10% early withdrawal penalty and may be grossed up accordingly.

Continued on next page

Hardship distributions, G-18, Continued

Employer cannot have discretion in determining hardship

Under Reg. 1.411(d)–4, a section 401(k) plan may not have a ‘‘catch-all’’ hardship category (for example, "and other events which the plan administrator deems to be hardships’’) because this would be impermissible employer discretion.

- The plan may be amended to add or eliminate a hardship category or to change the conditions for receiving a hardship distribution.

- A CODA may be amended to eliminate hardship distributions altogether without violating the anti-cutback rules of Code section 411(d)(6). See Treas. Reg. 1.411(d)-4, Q&A-2(b)(2)(x).

General hardship standards

Hardship must be both currently and effectively available.

Hardship distribution standards (general or deemed) must be both currently and effectively available to a group of participants that satisfies Reg. 1.401(a)(4)–4.

General hardship standards

Under the general hardship distribution standards, the determination of whether an employee has an immediate and heavy financial need is based on all the relevant facts and circumstances. Generally, for example, funeral expenses of a family member would qualify, whereas the need for a television would not.

Under the general hardship distribution standards, a distribution is not treated as necessary to satisfy an immediate and heavy financial need of the employee to the extent the need can be satisfied from other sources that are reasonably available to the employee.

> The plan must determine what other assets the employee has, such as, vacation homes, insurance policies, availability of loans from the plan or a bank (at reasonable rates), etc.

Employer can rely on written statements

The employer may rely on an employee's written statements that an amount is necessary or cannot be satisfied by other reasonably available means, unless the employer has actual knowledge to the contrary.

Loan is not reasonably available

A loan from a commercial source or from the plan (if available) is not reasonably available unless the full amount can be obtained from either. However, a plan may permit a combination of a plan loan up to the IRC 72(p) limits and a hardship distribution for the balance of the amount necessary to satisfy the financial need.

Deemed hardship standards

Introduction

An alternative to the general hardship distribution standards that eases the burden on the plan and the employer is the deemed hardship distribution standards.

The deemed standards do not involve other sources, assets or written statements of the employee and as such relieve the administrative burden associated with the general hardship distribution standards.

Deemed hardship items

Under the deemed hardship distribution standards, a distribution is deemed to be on account of an immediate and heavy financial need of the employee if it is for any of the following:

a) Medical expenses (as the term is defined in IRC section 213 but without regard to the AGI limit) incurred by the employee, spouse or dependant, to the extent not reimbursed by insurance. A distribution necessary to pay for procedures that have not yet occurred is permitted.

b) The purchase of a primary residence for the employee. (This does not include making mortgage payments.)

c) Post-secondary school tuition and tuition-like fees (e.g., lab fees) for the next 12 months.

d) The prevention of eviction or foreclosure from the employee's principal residence.

Continued on next page

Deemed hardship standards, Continued

Certain events must occur for deemed hardship items

Under the deemed hardship distribution standards, a distribution is deemed necessary to satisfy an immediate and heavy financial need of the employee if all of the following occur:

a) The distribution is not in excess of the amount needed (including applicable taxes and penalties),

b) The employee has obtained all distributions and nontaxable loans currently available under all plans maintained by the employer,

c) For plan years beginning before December 31, 2001:

   a. All plans of the employer limit the employee's elective contributions for the next year to the 402(g) limit for that year minus the employee's elective contributions for the year of the hardship distribution, and

   b. The employee is prohibited from making elective contributions and employee contributions to any plan of the employer for at least 12 months after receiving the distribution.

d) For plan years beginning after December 31, 2001:

   a. EGTRRA eliminated the post-hardship contribution limit for participants who receive a hardship distribution after December 31, 2000. Safe Harbor 401(k) Plans must eliminate this limit, but other non-Safe Harbor plans are permitted to make this elimination or they may retain a reduced limit.

   b. The suspension period following a hardship distribution was reduced to a minimum of 6 months by EGTRRA. A plan is permitted to retain a higher suspension period, except for Safe Harbor 401(k) Plans using the matching contribution safe harbor. These Safe Harbor 401(k) Plans must provide for the 6-month suspension period.

Continued on next page

Deemed hardship standards, Continued

Example-deemed hardship

Employer A maintains a section 401(k) plan that provides for hardship distributions under the deemed standards. The plan document contains language permitting participant loans.

In 1999, Participant B submits an application requesting a hardship distribution of $2,000 in order to make a down payment on a principal residence. At the time of the hardship distribution request, Participant B had an account balance of $50,000 and he did not have any outstanding loans from the plan.

The plan administrator approved the hardship distribution request and made a distribution of $2,000. The hardship distribution should not have been approved because Participant B should have received a nontaxable loan from the plan before any hardship distributions were made.

Examination steps—Hardship distributions-G-18

Inspect plan language

(1) Inspect the language in the plan document to determine when and under what circumstances distributions can be made.

(2) Inspect the language in the plan document to determine if hardship distributions are allowed and under what circumstances (general or deemed standards).

(3) Examine the plan document provisions pertaining to allowable distributions. If the plan provides for QNECs and QMACs, then these contributions are subject to the same restrictions as elective contributions, except that they generally cannot be distributed on account of hardship.

(4) Inspect the plan document to determine whether loans are available. If the plan provides for loans, then all nontaxable loans should be made prior to making any hardship distributions.

Continued on next page

Examination steps—Hardship distributions-G-18, Continued

Interview and Request information from plan administrator

Request from the Plan Administrator copies of hardship application files. Inspect these files to determine the reason the distribution was made.

A distribution generally may be treated as necessary to satisfy a financial need if the employer relies upon the employee's written representation, unless the employer has actual knowledge that the need can be reasonable relieved through reimbursement from insurance, by liquidation of the employee's assets, by cessation of elective contributions, or by other distributions or nontaxable loans from plans maintained by the employer. Interviewing the plan administrator may be necessary to determine the facts and circumstances surrounding questionable distributions.

Request copies of Form 1099-Rs for all distributions including hardship distributions. The hardship distribution amount may be increased for federal, state and local taxes.

Review hardship distributions

Review hardship distributions made from the plan during the year. Compare the amount distributed with the total elective contributions made by the participant to the plan.

Participant account statements should provide a separate breakdown of the elective contributions from other types of contributions. If the hardship distribution amount exceeds the employee's elective contributions, review the participant's account statements to verify the proper application of the grandfather rule for earnings, QNECs and QMACs.

If plan uses deemed hardship distributions

If the plan uses the deemed hardship distribution standards, inspect the employee's individual account statement for the applicable suspension period following the receipt of the hardship distribution to verify that the employee was prohibited from making elective contributions (and after-tax employee contributions) for the appropriate time period following receipt of the hardship distribution.

Contingent benefits-CODA disqualification issue, G-19

Overall audit step

- Determine whether the employer tied any benefits (other than matching contributions) to making contributions.
- If there are other plans, ensure there are no conditions affecting CODA participation, such as waiver of participation in other plans.

Overview-Contingent benefits

An employer may not directly or indirectly condition another employer benefit (other than matching contributions) upon an employee's election to make or not make elective contributions. This includes benefits under a DB plan, nonelective employer contributions to a DC plan, benefits under a nonqualified plan, the right to make employee contributions, the right to health and life insurance, and the right to employment.

A contingent benefit disqualifies the plan

If the employer has made an employer benefit conditioned upon elective contributions, the CODA is not qualified.

This rule is intended to prevent employers from encouraging employees to make or not make elective contributions by linking valuable benefits to the contribution or lack of a contribution.

Participation in a nonqualified plan may be contingent benefit

Participation in a nonqualified plan is treated as a contingent benefit only to the extent an employee may receive additional deferred compensation under the nonqualified plan depending on the employee's making or not making elective contributions.

However, participation in a nonqualified plan **is not** treated as a contingent benefit if an employee's participation is conditioned on making the maximum deferrals under IRC section 402(g) or the terms of the plan

Examination steps-contingent benefits—G-19

Interview employer	Ask whether the employer ties any benefits, other than matching contributions, to elective contributions. In certain circumstances, it may be appropriate to request an interview with employees who make or fail to make elective contributions to see if they get any special treatment from the employer.
Determine if nonqualified plan linked with CODA	Determine whether there is a nonqualified plan linked with the CODA. If there is, ensure there are no conditions in the form or in the operation of the nonqualified plan that are dependent on participation, lack of participation, or reduced participation in the CODA.

404 deduction and elective deferrals—90-105, G-20

Overall audit step

Verify 404 deduction comprised of elective deferrals made during taxable year—Rev. Rul. 90-105, G-20

Overview-404 deduction—cannot deduct for elective deferrals unless the compensation has been earned

Contributions to a qualified CODA (or to a defined contribution plan as matching contributions under 401(m) of the Code) **are not deductible** by the employer for a taxable year if the contributions are attributable to compensation earned by the plan participants after the end of the taxable year.

Although IRC section 404(a)(6) allows for additional time to take a deduction (tax return due date plus extensions), the deduction taken must relate to participants' income earned during the employer's taxable year.

90-105

Compensation cannot be deferred and contributed to a plan as elective deferrals, and matching contributions cannot be made to a plan with respect to such elective deferrals, until the underlying compensation has actually been earned. See Rev. Rul. 90-105, 1990-2 CB 69, December 7, 1990.

Contributions to a qualified CODA under section 401(k) or as matching contributions under section 401(m) are not deductible by the employer if the contributions are attributable to compensation earned by participants after the end of the employer's taxable year. This is true, regardless of:

- whether IRC section 404(a)(6) deems the contributions to have been paid on the last day of that taxable year and
- whether the employer uses the cash or accrual method of accounting.

Changes made by EGTRRA

NOTE: For years beginning after December 31, 2001, the IRC section 404 deductible limit was increased to 25% of compensation for stock bonus or profit-sharing plans.

In addition, Code section 404(n) was added to provide that elective deferrals are not considered when applying the 404 deductible limit

Examination Steps – IRC 404 Deduction of Elective Deferrals

Inspect employer's federal return

Inspect the employer's federal tax return (Form 1120, 990, 1065, etc.) to determine the taxable year of the employer.

Elective deferrals may appear in different areas of the employer's tax return, depending on the type of business and personal preferences.

Employees' deferrals may be included in the amounts reported as Compensation to Officers and/or Salaries and Wages. An employer may include deferrals in the cost of goods sold.

The deduction for Pension, profit sharing, etc. plans may include employee elective deferrals. Any of these may be appropriate as long as the deduction taken is accurate and within the applicable limits.

Review plan document and verify deductions

(1) Review the plan document and amendments to determine the plan year.

(2) Where the plan year and the employer's tax years are not the same, verify that the deductions taken were attributable to the participants' income actually earned during the employer's taxable year.

Conclusion, workpaper summary-G-21

Overall audit step	If form or operational defects were noted, please explain whether the examination was closed under the guidelines of SCP (APRSC) Rev. Proc. 2001-17 or CAP. (Also, explain unusual/noteworthy issues in the IRC 401(k) Workpaper Summary).
Provide brief synopsis	At the conclusion of the examination, you should provide a brief synopsis of the issues found and how they were resolved. In addition, the IRC 401(k) Workpaper Summary Sheet should be prepared on all cases.