COMPLIANCE PROFILE OF SECTION 401(k) PLANS: RESULTS OF AN IRS SURVEY

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I. INTRODUCTION

From 1995 to 1997 the Employee Plans field offices of the Internal Revenue Service (IRS or Service) examined 472 plans containing cash or deferred arrangements (CODAs) intended to be qualified under section 401(k) of the Internal Revenue Code (section 401(k) plans). After examining the plans, IRS Employee Plans (EP) examiners answered questions on a checksheet on the basis of the examinations (survey).

The primary purpose of the survey was to identify the areas in which section 401(k) plans failed to comply with the requirements of the Code (violations) and to obtain information on the size of the plans containing these violations. Some questions on the survey addressed compliance with Code sections that apply only to section 401(k) plans, while other questions addressed requirements that apply to tax-qualified plans in general, including section 401(k) plans. This report summarizes the information from the survey.

The original universe of 143,535 section 401(k) plans was identified by the Form 5500 Annual Return/Report of Employee Benefit Plan (with 100 or more participants) and the Form 5500-C/R Return/Report of Employee Benefit Plan (with fewer than 100 participants) filed for the 1993 plan year on the basis of information available as of December 1995 (not including Form 5500-EZ). Returns for the 1994 plan year were selected, if available, for the plans identified from the 1993 plan year. Thus, the survey results include 1994 data for these plans.

We excluded a number of these plans for various reasons. For example, plans that had been terminated or had no CODAs were excluded. Plans that EP specialists were unable to obtain sufficient data on to conduct an in-depth analysis were also excluded. These factors reduce the selectable plan population to approximately 130,000.

The sampling included a total of 550 plans that were divided into four groups, by size (according to the number of participants), consisting of 175 plans from each of the small, medium and large groups, and a super-large group consisting of the top 25 plans. Each IRS key district office (KDO) was allocated a proportionate share of plans based on the number of plans in each category located in the KDO.

The 550 plans were reduced to 472 plans after excluding some plans due to insufficient data or because they were not the types of plans intended to be included in the survey. Thus, the 472 plans were chosen from a population of approximately 130,000 section 401(k) plans.[1]

The groups of plans by size and the number of participants in each group are as follows:

Small (S) = 0 to 16 participants

Medium (M) = 17 to 53 participants

Large (L) = 54 to 60,000 participants

Super Large (SL) = 60,001 to 287,023 participants

The Service hopes that the information obtained from this survey will be useful to plan sponsors, employers, and others who have an interest in maintaining the tax-qualified status of their own section 401(k) plans by identifying where potential or existing violations are more likely to occur.

[1] Some of the responses to the questions in the survey were inconsistent or unclear. This report represents our best effort to compile and report the data.

II. OVERVIEW

Table 1, below, shows the number of plans, by size, containing one or more violations. Overall, 56% of plans had no violations.[2]

Table 1: Number of Plans Containing One or More Violations

Plan Size Category (Section 401(k) Plans)	Total Number of Plans	Plans With No Violations	Plans With One or More Violations	Percentage of Plans With No Violations (Margin of Error ±5–8 %)
All Plans	472	264	208	56%
Small Plans	139	82	57	59%
Medium Plans	162	86	76	53%
Large and Super Large Plans	171	96	75	56%

[2] It is important to note that, while Table 1 shows the number of plans containing one or more violations, it does not distinguish between plans containing one violation or plans containing more than one violation. Although some plans may have contained multiple violations, each plan is counted only once in reaching the totals in Table 1. The rest of this report generally describes the total number of times (instances) a violation occurred by size of plan. This is explained in section III below.

III. RESULTS OF SURVEY

The total instances of violations are reported in Categories A through P, below. This number, however, cannot be correlated to the number of plans containing these violations, because some plans may have contained more than one type of violation within a category. Thus, the total number of violations reported for a category may be greater than the number of individual plans with these violations.

For example, Category C, below, describes various types of violations involving loans to participants. There are 26 reported instances of miscellaneous loan violations. This does not necessarily mean that the violations occurred in 26 plans, because some plans contained more than one type of loan violation. The survey and this report do not show the number and types of violations occurring in any individual plan.

This report also discusses the requirements of the Code that apply to section 401(k) plans and changes in the law that have occurred since the survey was conducted. While the discussion is intended to put the survey results into context, it should not be regarded as a comprehensive explanation of the law.

A. DISTRIBUTIONS ELIGIBLE FOR ROLLOVER TREATMENT

The category with the highest reported instances of violations involved distributions from a qualified plan eligible for rollover treatment. Section 401(a)(31) of the Code provides that participants receiving an eligible rollover distribution must have the option to have the distribution transferred in the form of a direct rollover to another eligible retirement plan. If an eligible rollover distribution is not transferred by a direct rollover, the distribution is subject to withholding at a 20% rate, under section 3405(c)(1). Under section 402(f), and income tax regulations, a plan administrator must provide a written explanation within a specified period of time before making an eligible rollover distribution, explaining how funds may be transferred, when withholding of tax applies, the 60-day rollover rules, and other special rules noted under section 402(f) that may apply.

1. Total Violations

In 1994, distributions were made from 372 plans. EP specialists completing the survey reported 33 instances of violations relating to distributions eligible for rollover treatment. The different types of violations are described in further detail below.

2. Types of Violations Relating to Distributions Eligible for Rollover Treatment

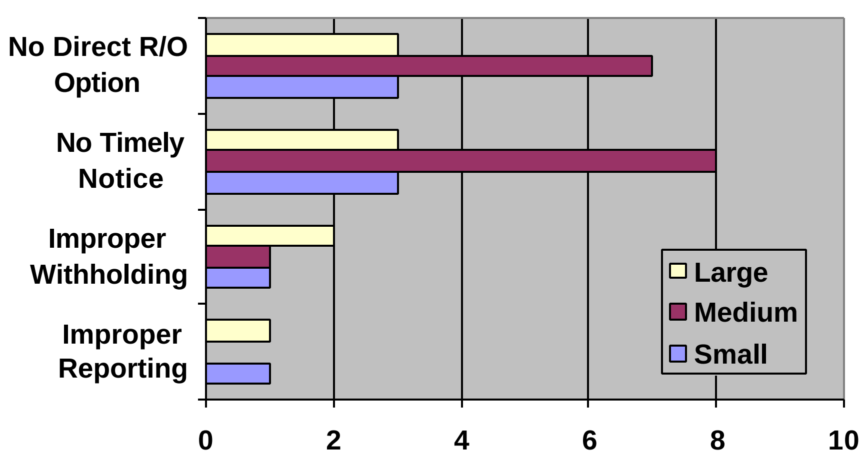
a) Direct Rollover Option - EP examiners reported that, in 13 plans (3S, 7M, 3L), participants were not given an option to elect to transfer an eligible rollover distribution directly to another eligible retirement plan, such as an IRA or another qualified plan.

b) Timely Notice - The section 402(f) notice was not timely given with respect to eligible rollover distributions from 14 plans (3S, 8M, 3L).

c) Improper Withholding - Improper withholding or no withholding on distributions occurred with respect to 4 plans (1S, 1M, 2L).

d) Improper Reporting - For 2 plans, distributions were either improperly reported or not reported on the Form 1099-R (1S, 1L).

Chart 1: Violations Involving Distributions Eligible for Rollover Treatment by Size of Plan



B. NONDISCRIMINATION (ADP/ACP)

The nondiscrimination in amounts test under section 401(a)(4) for a section 401(k) plan is the actual deferral percentage (ADP) test under section 401(k)(3). This test compares the amounts contributed by the highly compensated employees (HCEs) expressed as a percentage of compensation with the amounts contributed by the nonhighly compensated employees (NHCEs) expressed as a percentage of compensation.

The amount of elective contributions made under the section 401(k) plan is deemed to satisfy section 401(a)(4) if the section 401(k) plan satisfies the section 410(b) coverage and the ADP test of section 401(k)(3)(A). The generally applicable nondiscrimination rules still apply with respect to the availability of each level of section 401(k) contributions and of each benefit, right or feature under the section 401(k) plan. In addition, other parts of a plan that include the section 401(k) CODA must satisfy the generally applicable nondiscrimination rules under section 401(a)(4).

Special nondiscrimination tests, similar to those that apply to section 401(k) plans, apply to matching and after-tax employee contributions under section 401(m). A plan must pass the nondiscrimination rules with respect to the availability of matching and after-tax contributions. It must also pass the actual contribution percentage (ACP) test, similar to the ADP test. The main difference is that the entire plan is disqualified if the ACP test is not met, while a section 401(k) plan that fails the ADP test can be re-tested under the general nondiscrimination test of section 401(a)(4).

Multiple use (MU) occurs where a section 401(k) plan is subject to both the ADP and ACP tests and both tests can only be satisfied using the alternative limitations of those tests described under section 401(k)(3) and section 401(m)(2) (the 2 percentage point limit or the 200 percent limit). The purpose of the multiple use test is to prevent the multiple use of the more generous alternative for meeting the ACP and ADP test when certain employees are eligible under both a section 401(k) plan and a section 401(m) plan.

Corrective measures must be taken if a plan fails one or more of these tests. Correction involves distribution of excess contributions or excess aggregate contributions, recharacterization of excess contributions, making special employer contributions, or a combination of these methods, as described in the regulations accompanying sections 401(k) and 401(m).

1. Total Violations

There were 28 instances of reported violations.[3]

2. Subcategories

a) Failing to Include All Eligible Employees - In 15 plans (3S, 3M, 9L) there was a failure to include all of the eligible employees (including those who did not make an elective contribution to the plan) in the ADP test.

b) Failing ADP/ACP/MU - There were 13 plans (2S, 5M, 6L) that failed to pass the ADP, ACP, and/or the MU tests. There was no evidence that these plans had attempted to correct for this failure. The data does not indicate which particular test was failed in each case.

3. Law Changes

The Small Business Job Protection Act of 1996, Pub. L. 104-188, (SBJPA), made several changes that simplified the calculation of the ADP and ACP tests for employers. These changes should result in a lower incidence of noncompliance for years after the effective date of the changes.

a) SIMPLE 401(k) Plans

SBJPA section 1422 provides that, effective for years beginning after 12/31/96, a section 401(k) plan is deemed to have satisfied the ADP and ACP tests if the plan satisfies requirements for a Savings Incentive Match Plan for Employees (SIMPLE), under section 401(k)(11). In addition, a SIMPLE 401(k) plan is not subject to the top-heavy rules under section 416 of the Code. Several restrictions apply, including the

[3] We encountered problems analyzing the series of questions answered by EP examiners relating to whether the ADP and ADP tests were passed. For example, some responses to the survey stated that a particular test was failed, without taking into account that the plan had properly corrected for excess amounts in accordance with the regulations. Because it was unclear whether the test(s) might have been met by correction, we did not include these reported failures in our count of violations.

requirement that employees' elective deferrals must be limited to $6,000 and the employer must either make matching contributions up to 3% of compensation or make a 2% nonelective contribution on behalf of all eligible employees with at least $5,000 in compensation. The contributions must be 100% vested. Similar rules apply under section 401(m). See sections 401(k)(11) and 401(m)(10) of the Code for additional rules applicable to SIMPLE 401(k) plans.

b) Prior Year Data

SBJPA section 1433(c) amended sections 401(k)(3)(A) and 401(m)(2)(A) to provide that prior year data for NHCEs can be used in the ADP and ACP tests, effective for years beginning after December 31, 1996. Current year data is used for HCEs. Thus, in addition to prior year data on contributions and compensation, the individuals taken into account in determining the prior year's ADP and ACP for NHCEs are those individuals who were NHCEs during the preceding year, without regard to the individual's status in the current year.

This change simplifies plan administration because employers can determine the percentage of elective deferrals and matching contributions that can be made for HCEs early in the plan year and have more time to plan for correction to avoid all penalties. Current year data may also be used for determining the ADP and ACP for both HCEs and NHCEs under certain conditions. See Notice 97-2, 1997-1 C.B. 348 and Notice 98-1, 1998-3 I.R.B. 42.

c) Safe Harbor Method

SBJPA section 1433(a) and (b) provides for an alternative way to satisfy the ADP and ACP tests, effective in 1999. This is a safe harbor method described in sections 401(k)(12) and 401(m)(11) of the Code that permits a plan to satisfy the tests through plan design rather than by testing actual contributions. The ADP safe harbor requires that a plan meet one of two contribution requirements (matching or nonelective contributions of a stated amount) and a notice requirement. These contributions are required to be nonforfeitable and are subject to restrictions on withdrawals that apply to an employee's elective deferrals to a qualified section 401(k) plan under section 401(k)(2)(B) and (C). The ACP safe harbor is similar to the ADP safe harbor except that this test does not provide an alternate way to satisfy the ACP test for employee contributions. See Notice 98-52, 1998-46 I.R.B. 16, and Notice 2000-3, 2000-4 I.R.B. 413.

d) Correction of Excess Amounts

The SBJPA also changed the way in which excess amounts are allocated to HCEs, when distributions of excess contributions and excess aggregate contributions are made. If the plan does not meet section 401(k) and 401(m) nondiscrimination tests, an acceptable way to correct for the ADP test is to distribute excess contributions to the HCEs (excess elective contributions including QNECs and QMACs that are treated as elective contributions), and for the ACP test to distribute excess aggregate contributions to the HCEs (excess matching and employee contributions and any QNECs and elective contributions taken into account in computing the contribution percentage).

The SBJPA did not change the method for determining the dollar amount of the reduction (the leveling method) but did change how that dollar amount is distributed, effective in 1997. Under the SBJPA, a plan that provides for distributions of excess contributions must be amended to provide that excess contributions are distributed to the HCEs with the highest dollar amount of elective contributions (rather than the highest percentages). Returning excess contributions to correct the ADP failure (or excess aggregate contributions to correct the ACP failure) is based on each HCE’s elective contributions expressed as a straight dollar amount, rather than on an HCE’s elective contributions expressed as a percentage of compensation (the pre-SBJPA rule). This method often results in more highly paid HCEs receiving distributions than under the pre-SBJPA rule. See Notice 97-2.

C. LOANS

Although violations of section 72(p) may or may not affect the qualification of the plan, depending on whether there is loan language in the plan, these violations can cause adverse tax consequences to participants. Section 72(p) of the Code and section 1.72(p)-1 of the Proposed Income Tax Regulations provide that a loan from a qualified plan is treated as a deemed distribution, unless the loan meets certain requirements. These include a dollar limit, a time period for repayments, an amortization schedule and a legally enforceable loan agreement.

The loan (1) may not exceed the lesser of (a) $50,000, reduced by certain outstanding loans, or (b) 1/2 of the present value of the employee's nonforfeitable accrued benefit (or $10,000, if more), (2) must be repaid within 5 years except for certain home loans, (3) must meet amortization requirements, with substantially level payments not less frequently than quarterly, and (4) must be evidenced by a legally enforceable agreement specifying the amount, term and repayment schedule of the loan.

A deemed distribution generally occurs when any of these requirements are not satisfied in form or in operation. The amount includible in income, as a result of a deemed distribution under section 72(p), must be reported on Form 1099-R.

A deemed distribution is not treated as a distribution for purposes of some other sections of the Code (including section 401(k)(2)(B), which limits distributions to certain events). However, offsetting an account balance to repay a plan loan is treated as an actual distribution. A plan may be prohibited from making such an offset under section 401(k)(2)(B) or other sections. Note that section 1.72(p)-1 of the proposed regulations describing applicable requirements is not effective until after the publication of final income tax regulations.

1. Total Violations

A total of 189 plans had loans outstanding in either 1993 or 1994. There were 26 instances of miscellaneous violations, as described below.

2. Types of Reported Loan Violations

a) Exceeding Dollar Limit – In one small plan loans were not limited to the required dollar limit of $50,000.

b) Not Meeting Amortization and/or Repayment Requirements – Loans from 8 plans did not meet the amortization and/or repayment schedules (4S, 3M, 1L).

c) Exceeding Loan Term – Loans from 3 plans did not meet the 5-year maximum term limit (1S, 1M, 1L).

d) Default Without Collection – EP specialists reported that 23 plans had loans that were in default. However, out of the plans with loans made that were in default, only those that did not have collection procedures or did not follow them were non-compliant. See i and ii below.

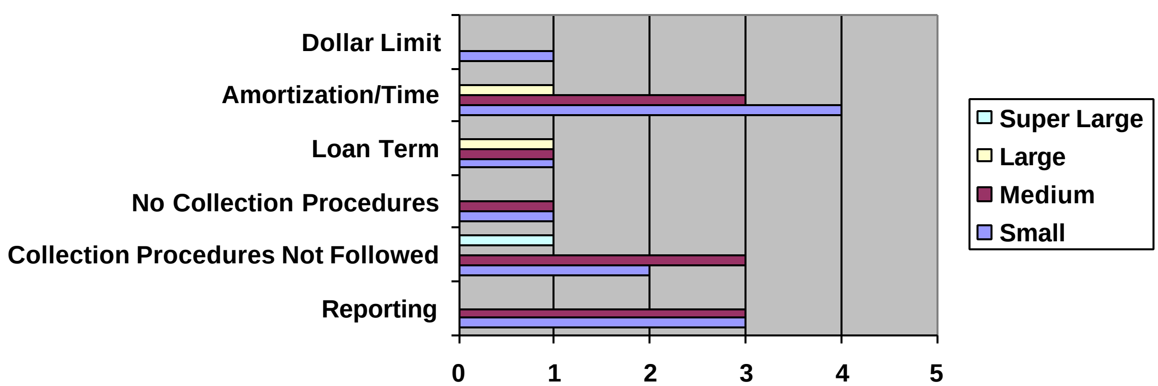
(i) No Collection Procedures - Of the 23 plans with loans in default, 2 (1S, 1M) had no procedures to handle collections when loan payments are late.

(ii) Procedures Not Followed - Of the remaining 21 plans, there were 6 plans (2S, 3M, 1SL) that did not follow collection procedures.

Thus, there were 8 instances of noncompliance relating to default without collection.

e) Improper Reporting - A Form 1099-R was not issued upon default with respect to 6 plans (3S, 3M).

Chart 2: Loan Defects by Plan Size



D. CONTINGENT BENEFITS

Section 401(k)(4)(A) provides that a section 401(k) plan may not make any other benefit provided by the employer contingent on the employee making elective deferrals in lieu of receiving cash. This rule does not apply to matching contributions under section 401(m) or certain other types of benefits.

1. Total Violations

In 24 plans (3S, 11M, 9L, 1SL) other benefits were made contingent on elective deferrals. However, the survey did not gather data on the nature of the contingent benefits.

E. HARDSHIP DISTRIBUTIONS

Section 401(k)(2) of the Code provides that distributions from section 401(k) plans may only occur on certain stated events. In the case of amounts attributable to elective contributions under a section 401(k) plan in a profit-sharing or stock bonus plan, distributions may be made on account of a hardship of the employee. Special rules apply, as described in section 1.401(k)-1(d)(2) of the regulations. A distribution is made on account of the employee's hardship only if the distribution is (1) made on account of an immediate and heavy financial need of the employee and (2) is necessary to satisfy the financial need.

The determination of the existence of an immediate and heavy financial need and of the amount necessary to meet the need must be made in accordance with nondiscriminatory and objective standards set forth in the plan.

Whether an immediate and heavy financial need exists depends on facts and circumstances. Certain stated distributions are deemed to be on account of an immediate and heavy financial need (safe harbors).

The facts and circumstances also determine whether the distribution is necessary to satisfy the financial need. A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the amount of the distribution is in excess of the amount required to relieve the financial need or to the extent the need may be satisfied from other resources that are reasonably available to the employee. A distribution generally may be treated as necessary if the employer, without actual knowledge to the contrary, relies on an employee's written representation, that the need cannot reasonably be relieved from other sources listed in the regulations, including by other distributions or nontaxable loans from plans maintained by the employer or any other employer, or by borrowing from commercial sources on reasonable terms.

A distribution is deemed necessary to satisfy the financial need (safe harbor) if (1) the distribution is limited to the amount of the need, (2) the employee has obtained all distributions, other than hardship distributions, and all nontaxable loans currently available under all plans of the employer, (3) the plan and all other plans maintained by the employer limit the employee’s elective contributions for the next taxable year to the applicable limit under section 402(g) for that year minus the employee’s elective contributions for the year of the hardship distribution, and (4) the employee is suspended from making elective contributions or employee contributions for at least 12 months after the receipt of the hardship distribution.

1. Total Violations

In 1994, there were 329 plans permitting hardship distributions. Of these, 68 plans actually made hardship distributions in 1994, 54 of which were deemed safe harbor distributions. There were 20 violations as noted below. The first two subcategories below relate specifically to whether a safe harbor provision for hardship distributions is met, while the next two subcategories could apply to the safe harbor provisions and to the general hardship distribution requirements.

2. Types of Violations Relating to Hardship Distributions

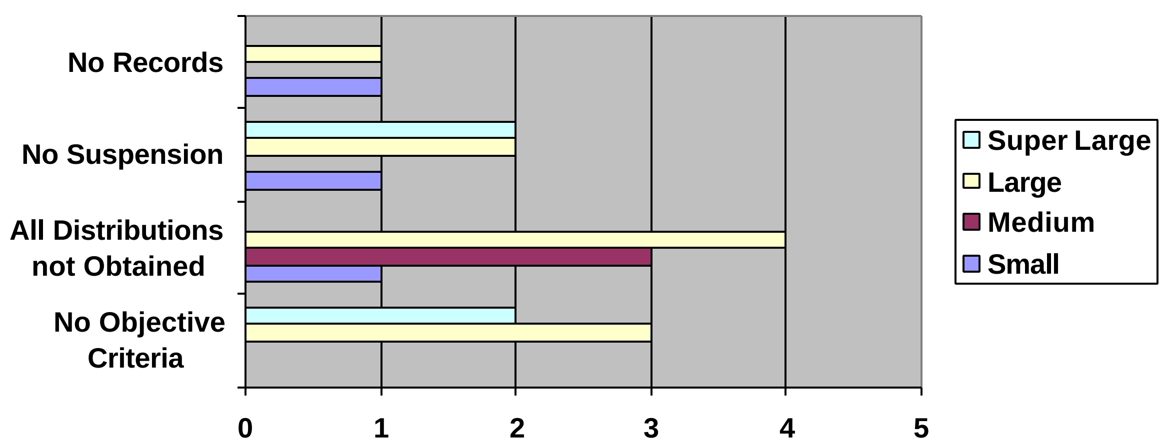
a) Substantiating Safe Harbor – For 2 plans (1S, 1L) there were no records substantiating the use of a safe harbor.

b) Failing to Suspend Contributions for 12 Months – In 5 plans (1S, 2L, 2SL) deferrals were not suspended for 12 months after employees received safe harbor distributions.

c) Not Obtaining All Other Distributions - In 8 plans (1S, 3M, 4L) the employee had not obtained all distributions and non-taxable loans under the sponsor's plans.

d) No Objective Criteria - 5 plans (3L, 2SL) did not have objective criteria for hardship distributions in the plan.

Chart 3: Hardship Violations by Plan Size



F. TOP-HEAVY REQUIREMENTS

A top-heavy defined contribution plan is a plan where the aggregate value of the accounts of key employees (certain officers, employees and owners as specified in section 416(i)) under the plan exceeds 60% of the aggregate value of the accounts of all employees. Section 416 and section 1.416-1 of the regulations provide rules for top-heavy plans including special vesting requirements and minimum benefit requirements. In a defined contribution plan, the minimum benefit requirements are met if the employer contribution for the year for each participant who is a non-key employee is the lesser of 3% of the participant's compensation or the maximum contribution rate made for any key employee.

As described in M-18, M-19 and M-20 of section 1.416-1 of the regulations, elective and matching contributions for a key employee are counted in determining the amount of employer contributions made for a key employee. However, elective contributions made on behalf of a non-key employee are not counted to determine whether that employee received the full required minimum contribution. Further, matching contributions that are used to satisfy the section 416 minimum contribution for a non-key employee may not be used to satisfy the nondiscrimination tests (ADP and ACP tests) applicable to section 401(k) plans and section 401(m), or vice versa. Finally, qualified nonelective employer contributions (QNECS) described in section 401(m)(4)(C) of the Code may be treated as employer contributions under 416 for non-key employees to satisfy the section 416 minimum contributions even if they are also taken into account for the ADP/ACP tests.

1. Total Violations

There were 18 reported violations out of the 79 plans that were top-heavy.

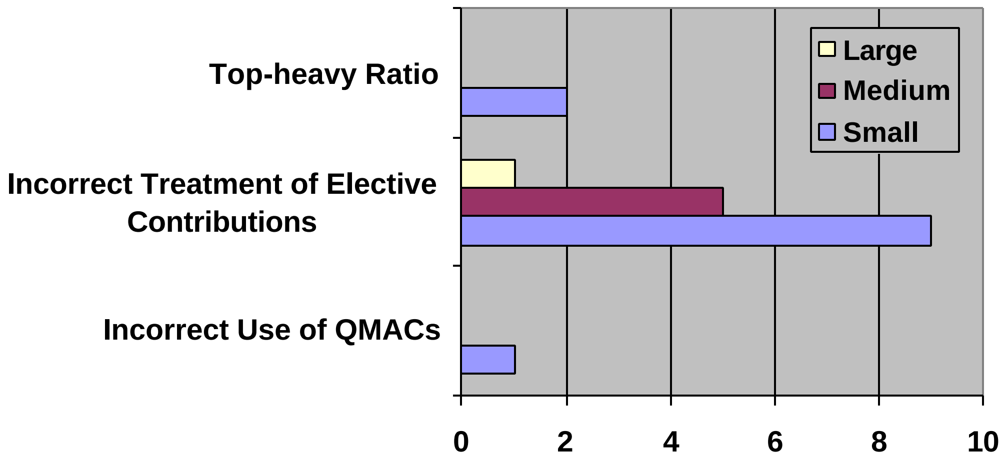
2. Types of Reported Top-heavy Violations

a) Calculating Top-heavy Ratio and Vesting - The responses to the survey indicated that the top-heavy ratio had been incorrectly calculated in 2 small plans. All plans satisfied vesting rules.

b) Incorrect Treatment of Elective Contributions - Elective contributions made on behalf of key employees are taken into account in determining the amount of employer contributions made for a key employee, to determine the minimum required contribution for non-key employees. Elective contributions made on behalf of non-key employees are not counted in determining whether the employer has satisfied required minimum contributions on behalf of non-key employees. This requirement was not met in 15 plans (9S, 5M, 1L). There were 36 incorrect N/A responses.

c) Use of QMACs - In 6 plans, QNECS were used to satisfy the minimum contribution requirements of section 416 of the Code, although this is not specifically a compliance factor. In 9 plans, QMACS were used to satisfy section 416. They were not taken out of the ACP test in 1 small plan.

Chart 4: Top-heavy Violations by Plan Size



G. COVERAGE

Section 401(k)(3)(A)(i) provides that a section 401(k) plan must satisfy the minimum coverage requirements of section 410(b)(1). Under section 410(b) and the accompanying regulations, a plan must satisfy either a ratio percentage test or an average benefit test. A section 401(k) plan is disaggregated from the rest of the plan and tested separately for coverage purposes. When applying the rules of section 410 to a section 401(k) plan, an expanded benefiting rule generally provides that employees who are eligible to participate are treated as employees who benefit, whether or not they actually elect to defer amounts under the section 401(k) plan (except for purposes of meeting part of the average benefit test).

If the section 401(k) plan does not satisfy coverage, it is no longer qualified. Under section 1.401(a)(4)-11(g)(3) the plan is permitted to make remedial amendments to increase or add a benefit to prevent a failure to satisfy coverage, but only if made within 10-1/2 months after the end of the plan year.

To apply the section 410(b) coverage rules, the HCEs, as defined under section 414(q) of the Code, must be properly identified. At the time of the survey, section 414(q) provided several categories for HCE status, based on compensation levels, officer status, and 5% owner status etc., over a 2-year period. Family members had to be taken into account under the family aggregation rules.

1. Total Violations

The responses with respect to passing the coverage test were generally favorable, although some answers were inconclusive or inconsistent. Sixteen responses indicated that HCEs were improperly classified, and/or that the plan did not pass section 401(k) plan coverage.

With respect to coverage applicable to non-section 401(k) plan components, one plan failed to pass. Out of a total of 472 plans, 403 indicated that the coverage test was satisfied. There were 14 incorrect or inconsistent responses. The remaining 54 plans contained either only HCEs or only NHCEs and no violations were reported for those 54 plans.

2. Types of Coverage Violations

a) Section 401(k) Plan Coverage

i) HCE Status - The HCEs were not properly classified in 12 plans (4M, 8L). Three plans (1M, 2L) did not apply the family aggregation rules when determining HCE status.

ii) Coverage Test - The ratio percentage test was not satisfied in 4 plans (1S, 2M, 1L). Of the 4 plans that did not satisfy the ratio percentage test, 3 satisfied the average benefit test. One medium plan failed coverage because the average benefit test was not satisfied.

b) Non-section 401(k) Portion Coverage

This issue only applied to 382 plans (those plans that had other types of contributions in addition to elective contributions).

In seven plans (4S, 1M, 2L) the ratio percentage test was not satisfied. Six of the seven plans satisfied the average benefit test. One small plan of these seven indicated that the average benefit test was not satisfied.

Table 2: Coverage Violations by Plan Size

Plan Size	Improper HCE Classification	No family Aggregation	CODA Coverage Failure	Non-CODA Coverage Failure
Small	0	0	0	1
Medium	4	1	1	0
Large	8	2	0	0
Super-Large	0	0	0	0

3. Law Change

Section 1431 of the SBJPA amended section 414(q) of the Code. The SBJPA simplified the definition of HCE by eliminating the 2- year analysis (in some cases) and several categories, and by repealing the family aggregation rules. Under the SBJPA, an employee will be considered an HCE if he or she is 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 elects, was in the top-paid group for that year. An employee is in the top-paid group if the employee was among the top 20% of employees of the employer when ranked on the basis of compensation paid to the employees during the preceding year. This applies to years beginning after 12/31/96 except that in determining whether an employee is an HCE for years beginning in 1997, such amendments will be treated as having been in effect for years beginning in 1996.

Section 414(q)(6) required that compensation and certain benefits for HCEs be aggregated with that of certain listed family members. Section 1431 of the SBJPA repeals these family aggregation rules, effective for years beginning after 12/31/96, so family members will not be treated as HCEs due to family aggregation for purposes of the rules applicable to section 401(k) plans and other sections of the Code.

H. SECTION 415

Section 415(c) of the Code limits the maximum contributions that a qualified plan can provide. Contributions and other additions (annual additions) for a participant under a defined contribution plan may not exceed the lesser of $30,000 or 25% of the participant’s compensation. Section 1.415-6 of the regulations describes limited circumstances under which an employer is allowed to correct excess annual additions.

Before 1998, the definition of compensation, for purposes of determining the 25% limit of compensation under section 415, applied to compensation after excluding elective contributions (e.g. amounts that a participant elects to have the employer contribute on the participant's behalf to a section 401(k) plan) and certain other salary reductions. The survey responses revealed that some section 401(k) plans incorrectly included elective contributions in the definition of compensation.

Other problems involved failing to treat certain amounts as annual additions subject to section 415 limits. Contributions under a defined contribution plan that are considered to be annual additions subject to the overall limit under section 415(c)(1) include elective contributions, nonelective employer contributions and after-tax employee contributions, and forfeitures.

1. Total Violations

EP examiners reported that there were 13 instances of section 415 violations. In 21 other cases there may have been 415 violations but the responses did not provide sufficient detail to state clearly whether or not there was such a violation. The 13 responses reported the following problems described below.

2. Types of Section 415 Violations

a) Use of Elective Contributions – In 11 plans (3S, 4M, 3L, 1SL) elective contributions were included in compensation for 415 purposes. Section 1434 of the SBJPA changed section 415 and other applicable Code sections to provide that, effective for years after 12/31/97, compensation includes elective contributions to section 401(k) plans and certain other contributions for purposes of determining the 25% limit. Thus, this question in the survey is no longer applicable as a noncompliance factor.

b) Treatment of Annual Additions - Of the 71 plans that allowed after-tax employee contributions, there was a failure to include after-tax employee contributions as annual additions under section 415 in 2 medium plans. There were 3 incorrect N/A responses.

I. NONDISCRIMINATION UNDER SECTION 401(a)(4)-GENERAL

As noted above, the nondiscrimination rules still apply with respect to the availability of each level of contributions and of each benefit, right or feature under the section 401(k) plan. A plan that includes a section 401(k) plan must also satisfy the nondiscrimination rules under section 401(a)(4). If an employer has only HCEs, or if the plan benefits no HCEs, the nondiscrimination rules are satisfied.

1. Total Violations

There were 13 reported instances of general section 401(a)(4) violations.

2. Types of Reported Violations

a) Nondiscrimination in Amount - In 2 plans (2M) contributions to the non-section 401(k) portion of the plan did not satisfy the nondiscrimination in amounts testing rules.

b) Current and Effective Availability - In 3 plans (1S, 1M, 1L) benefits, rights and features were not currently and effectively available to all employees uniformly, and were not available to a nondiscriminatory group.

c) Pattern of Amendments - In 3 plans (1L, 2SL) there was a pattern of amendments giving and taking away the same benefits.

The remaining 5 responses indicated that there were general nondiscrimination problems but did not specify the nature of the problem. For these 5 there is no information available as to plan size.

Table 3: Nondiscrimination Violations by Plan Size

Plan Size	Nondiscrimination in amount	Current and effective availability	Pattern of amendments
Small	0	1	0
Medium	2	1	0
Large	0	1	1
Super Large	0	0	2

J. VESTING

Contributions made to section 401(k) plans are subject to different vesting requirements depending on the type of contribution. Elective deferrals under section 401(k)(2)(C), matching contributions that are QMACs and nonelective contributions that are QNCES must be nonforfeitable.

QNECS and QMACs are defined in section 1.401(k)-1(g)(13) of the regulations. Matching contributions that are not QMACs and nonelective employer contributions that are not QNECs, may be subject to a vesting schedule, instead of being immediately nonforfeitable.

1. Total Violations

There were nine responses reporting violations of vesting requirements.

2. Types of Violations Involving Vesting Rules

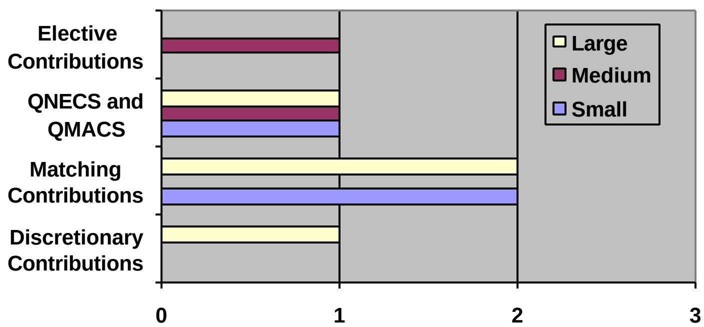
a) Elective Contributions - In 1 medium plan, elective contributions were not 100% vested. Three responses to the survey were left blank.

b) QNECS and QMACS - Out of a group of 318 plans that had employer contributions, 3 (1S, 1M, 1L) did not have QNECs and QMACs that were 100% vested when made. It is unclear from the responses whether this refers to QNECS and QMACs separately or to both.

c) Matching Contributions - In 4 plans (2S, 2L), contributions were not vested in accordance with plan provisions. Presumably this refers to matching contributions other than QMACs. Some responses left the item blank and there were 159 n/a responses.

d) Discretionary Contributions - In 1 large plan employer discretionary contributions other than matching contributions were not vested according to plan provisions. 317 responses stated n/a. The answer was left blank in 2 survey responses.

Chart 5: Vesting Violations by Plan Size



K. PROHIBITED TRANSACTIONS

Section 4975 of the Code prohibits certain transactions between a plan and a disqualified person. Statutory exemptions are listed in the Code. Administrative exemptions are published by the Department of Labor (DOL). Similar rules are contained in section 406 of ERISA.

1. Total Violations - Non-exempt prohibited transactions occurred in 8 plans (2S, 2M, 3L, 1SL). The survey responses did not identify the specific type of prohibited transaction.

L. PLAN ASSET RULE

The DOL provides rules as to when participant contributions, held by the employer, become plan assets. Once participant contributions become plan assets they are subject to the fiduciary requirements of section 403 of ERISA. This requirement is imposed to prohibit commingling of assets with an employer's own property. Other fiduciary responsibilities also apply.

The DOL's general position is that plan assets include amounts to be contributed to the plan that are paid by a participant to the employer or withheld by an employer from a participant's wages as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets. Under DOL regulation section 2510.3-102, as in effect when this survey was conducted, the maximum length of time employers had to treat participant contributions to pension plans as other than plan assets was 90 days from the time these contributions were withheld by the employer or paid by the participant and received by the employer.

The time period for allocating elective contributions to an employee's account under the section 401(k) regulations does not correspond to the DOL periods. Section 1.401(k)-1(b)(4)(i) of the regulations provides that an elective contribution is taken into account for the ADP test for a plan year only if certain requirements are met. With respect to allocations, the elective contribution must be allocated to the employee's account under the plan as of a date within that plan year. For purposes of this rule, an elective contribution is considered allocated as of a date within a plan year only if the allocation is not contingent upon the employee's participation in the plan or performance of services on any date subsequent to that date, and the elective contribution is actually paid to the trust no later than the end of the 12-month period after the plan year to which the contribution relates.

1. Total Violations

Salary deferrals were contributed to 8 plans (3S, 3M, 2L) more than 90 days after being withheld from a participant's salary.

2. Law Change

Unlike many of the rules that have been changed in recent years, making it easier for employers to comply with qualification requirements, the plan asset rule has been revised to become more restrictive for employers. Section 2510.3-102 of the DOL regulations was revised to limit the period that assets can be treated as other than plan assets to 15 business days after the end of the month in which contributions were withheld or received, with a 10 - day extension possible, if the employer meets all of the notice and other requirements set forth in the regulations. This rule was effective Feb. 3, 1997, with special extended dates under certain conditions, including a delayed effective date for collectively bargained plans and a period of 30 days for SIMPLE IRA plans under section 408(p).

M. PARTNERSHIP ISSUES

Section 1.401(k)-1(a)(6) provides that partnerships may maintain CODAs. A CODA under a partnership includes any arrangement that directly or indirectly allows partners to vary the amount of contributions made to a plan on their behalf. Generally partnership CODAs are subject to the same rules as apply to other CODAs and are not qualified unless the requirements of section 401(k) are met. However, there are some differences. A partner's compensation is deemed to be currently available on the last day of the partnership's taxable year, so a cash or deferred election may not be made after the last day of that year. Also, a rule applicable at the time of the survey (which has now been changed) provides that the matching contributions made by a partnership with respect to an individual partner's elective or employee contributions are treated as elective contributions made on behalf of the partner.

1. Total Violations

There were 25 partnerships maintaining section 401(k) plans identified in the survey. Four responses to the survey indicated that partners may elect in and out of the non-section 401(k) part of the plan. Allowing such elections may cause a compliance problem because a plan that allows partners to elect in or out at will is deemed to be a CODA. However there is no further detail on whether a specific violation occurred for this reason. There were six incorrect n/a responses.

All contributions for electing-in partners, including matching contributions, are treated as elective contributions, thereby resulting in potential section 402(g) or ADP/ACP failures. There were 3 violations reported below with respect to this requirement.

2. Not Counting Matching Contributions to Partners as Elective Contributions

Matching contributions were made in 11 plans. In 3 plans (2M, 1L) matching contributions were not counted as elective contributions. There were 7 incorrect n/a responses.

3. Law Change

Section 402(g)(9), as added by section 1501 of the Tax Reform Act of 1997, provides that a matching contribution made on behalf of a self-employed individual is not treated as an elective contribution, effective for years beginning after 12/31/97 (after 12/31/96 for SIMPLE plans). Thus, matching contributions for partners are now treated the same as for all employees. They are not treated as elective contributions and are not subject to the section 402(g) limits or the ADP or ACP test. This change does not apply to QMACs that are treated as elective contributions for purposes of satisfying the ADP test.

N. PARTICIPATION

When the survey was conducted, section 401(a)(26) provided that a plan must benefit at least 50 employees or 40% of the employees, whichever is less. Plans may not be aggregated to satisfy this rule, and the overall plan must be disaggregated into section 401(k) portions and non-401(k) portions, among other requirements, before testing for section 401(a)(26).

There were no reported violations of this requirement for the section 401(k) portions or the non-section 401(k) portions. One plan had unusable data. The SBJPA revised section 401(a)(26) so that it applies only to defined benefit plans, effective for years beginning after 12/31/96.

O. MISCELLANEOUS LIMITS

Section 401(a)(17) of the Code limits the amount of compensation that may be taken into account for any employee to $150,000, as adjusted annually for cost of living. There was no reported noncompliance with this limit.

Section 402(g) limits the amount of elective contributions that can be excluded from an individual's gross income to $7000 (as adjusted for cost of living.) The responses to questions on whether the limit was met were inconclusive. In addition, there were 101 responses that left the answer to this question blank. Thus, we were unable to properly interpret and report the data.

P. MISCELLANEOUS VIOLATIONS

General questions on the survey asked whether the plan and/or the section 401(k) arrangement was qualified, and if not, to explain the reason(s).

Fifteen plans (3S, 4M, 7L, 1SL) were identified as not qualified under section 401(a). Some of these plans entered into a closing agreement with the Service.

Fifteen plans (3S, 6M, 6L) did not contain a qualified section 401(k) arrangement, but not all of these had disqualifying features under section 401(a). In most of these plans, the ADP test was failed.

The types of violations reported included excluding employees from coverage, failing to distribute promised cash-out distributions under $3,500 to employees under section 411 (now raised to $5,000), failing to obtain spousal consents before distributions, failing to distribute under section 401(a)(14), failing to adopt and amend the plan and violating section 415.

In one large plan the market value of plan assets was not determined on a regular basis.

IV. CORRECTION PROGRAMS

Some violations can be corrected under the Code and regulations such as corrections in specified circumstances for failing to meet the nondiscrimination tests under sections 401(k) and 401(m). The Service has also implemented a variety of correction programs. These programs enable employers and plan sponsors to retain the qualified status of their plans. Since 1992, there have been several voluntary correction programs allowing employers to correct violations in their retirement plans. The Service has also established a closing agreement program for form violations and for plans under audit.

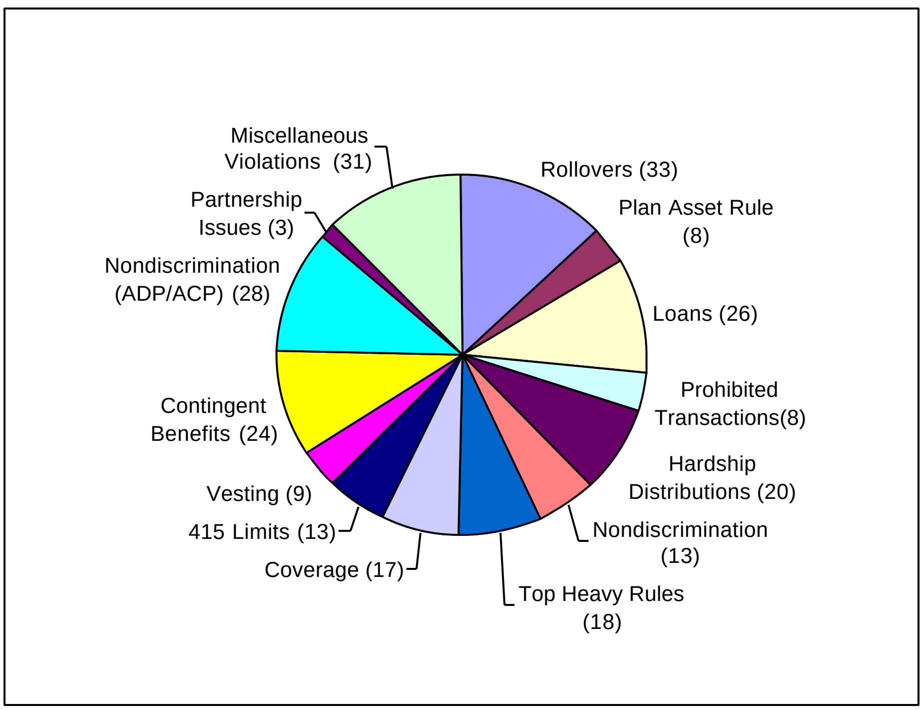
These programs have been expanded and revised to address a variety of needs. This coordinated system of correction programs is referred to as the Employee Plans Compliance Resolution System (EPCRS). The correction programs comprising EPCRS, described in Rev. Proc. 2000-16, 2000-6 I.R.B. 518, include the Administrative Policy Regarding Self Correction (APRSC), Voluntary Compliance Resolution Program (VCR Program) including the Standardized VCR Procedure (SVP), Walk-in Closing Agreement Program (Walk-in CAP), the Tax-Sheltered Annuity Voluntary Correction Program (TVC) and the Audit Closing Agreement Program (Audit CAP). If the eligibility requirements of a correction program are satisfied and the sponsor or employer corrects a failure in accordance with the principles set forth under EPCRS, the IRS will not, on account of the corrected failure, pursue disqualification of the plan. Employers and plan administrators with plans containing defects that cannot be appropriately corrected under existing regulations and other guidance are encouraged to review the EPCRS requirements to determine whether they are eligible under these programs.

V. SUMMARY

Section 401(k) plans of all sizes contained violations. As discussed in this report, laws enacted since this survey was conducted have simplified and /or changed certain rules, including some that apply to areas covered in the survey.

Although some violations reported in this survey are no longer violations after the law changes, and some requirements have been simplified, (such as the determination of HCE status and the possibility that the ADP and ACP tests may be automatically satisfied), future guidance from the Service and continued scrutiny by employers, plan administrators and the Service is warranted. We believe that the results of this survey will assist plan sponsors and employers in maintaining plans that comply with the Code by highlighting potential problem areas.

VI. INSTANCES OF VIOLATIONS BY CATEGORY – CHART 6



Total violations: 251

VII. SUMMARY OF VIOLATIONS BY PLAN SIZE – TABLE 4

This table summarizes the violations reported by EP examiners listing specific violations within a category by plan size.

Description of Violations	Total Violations	S	M	L	SL
A. Rollover (R/O) Rules	**33**				
Gave no direct R/O Option	13	3	7	3	0
No Timely Notice	14	3	8	3	0
Improper Withholding	4	1	1	2	0
Improper Reporting	2	1	0	1	0
B. Nondiscrimination (ADP/ACP)	**28**				
Not including employees	15	3	3	9	0
Failure to pass tests	13	2	5	6	0
C. Loans	**26**				
Dollar Limit	1	1	0	0	0
Amortization/Time	8	4	3	1	0
Loan Term	3	1	1	1	0
Default w/o Collection	8	3	4	0	1
Improper Reporting	6	3	3	0	0
D. Contingent Benefits	**24**	3	11	9	1
E. Hardship Distributions	**20**				
No Records	2	1	0	1	0
Failure to Suspend	5	1	0	2	2
No Other Distributions	8	1	3	4	0
No Objective Criteria	5	0	0	3	2
F. Top-heavy Rules	**18**				
Top-heavy Ratio	2	2	0	0	0
Elective Contributions	15	9	5	1	0
Use of QMACS	1	1	0	0	0
G. Coverage	**17**				
HCE Determinations	15	0	5	10	0
Coverage Test	1	0	1	0	0
NonCODA Coverage	1	1	0	0	0
H. 415 Limits	**13**				
Electives incl. In Comp.	11	3	4	3	1
Annual Additions	2	0	2	0	0

Description of Violations	**Total Violations**	**S**	**M**	**L**	**SL**
I. Nondiscrimination (401(a)(4))	**13**				
Amount	2	0	2	0	0
Availability	3	1	1	1	0
Pattern of Amendments	3	0	0	1	2
General	5 (no info by plan size)				
J. Vesting	**9**				
Elective Contributions	1	0	1	0	0
QNECS/QMACS	3	1	1	1	0
Matching Contributions	4	2	0	2	0
Discretionary	1	0	0	1	0
K. Prohibited Transactions	**8**	2	2	3	1
L. Plan Asset Rule	**8**	3	3	2	0
M. Partnership Issues	**3**	0	2	1	0
N. Participation(no failures)	**0**	0	0	0	0
O. Misc. Limits (no failures)	**0**	0	0	0	0
P. Misc. Violations	**31**				
Nonqualified 401(a) Plan	15	3	4	7	1
Nonqualified CODA	15	3	6	6	0
Improper Valuation	1	0	0	1	0