Internal Revenue
bulletin

Bulletin No. 2003-35
September 2, 2003

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

REG–133791–02, page 493.

Taxpayers may receive a tax credit for certain expenses incurred in conducting qualified research. Proposed regulations under section 41 of the Code provide guidance on the proper method for computing and allocating the research credit for members of a controlled group of corporations or a group of trades or businesses under common control. A public hearing is scheduled for November 13, 2003. REG–105606–99 withdrawn.

REG–162625–02, page 500.

Proposed regulations under section 446 of the Code set out rules relating to the proper timing and source of income of fees received to induce the acquisition of noneconomic residual interests in REMICs. A public hearing is scheduled for November 18, 2003.

EMPLOYEE PLANS

T.D. 9081, page 420.
REG–129709–03, page 506.

Temporary and proposed regulations under section 409(p) of the Code provide guidance concerning the requirements for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. A public hearing on the proposed regulations is scheduled for November 20, 2003.

REG–108639–99, page 431.

Proposed regulations under sections 401(k) and 401(m) of the Code provide guidance on the requirements for certain retirement plans containing cash or deferred arrangements and providing for matching contributions or employee after-tax contributions. These regulations affect certain plans or contracts providing for elective deferrals under section 401(k), matching contributions or employee after-tax contributions under section 401(m), and participants eligible under these plans or contracts. A public hearing is scheduled for November 12, 2003.

REG–112039–03, page 504.

Proposed regulations under section 411 of the Code amend section 1.411(d)–4, of the regulations to reflect the addition of section 411(d)(6)(E) by the Economic Growth and Tax Relief Reconciliation Act of 2001. The proposed regulations retain rules under which a defined contribution plan could be amended, but remove the 90-day notice condition.

Notice 2003–58, page 429.

Weighted average interest rate update. The weighted average interest rate for August 2003 and the resulting permissible range of interest rates used to calculate current liability for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

ADMINISTRATIVE

Notice 2003–59, page 429.

Uniform capitalization; methods of accounting. This notice modifies Notice 2003–36 to permit certain taxpayers to use the automatic approval procedures of Rev. Proc. 2002–9 to change their method of accounting to the simplified service cost or simplified production method for self-constructed assets for their most recent taxable year ending on or before May 8, 2003. This notice also informs taxpayers that, in the future, the Service and Treasury Department may provide guidance under which the automatic approval procedures will no longer apply to a method of accounting, effective for applications filed after such change is announced. Notice 2003–36 modified.

Finding Lists begin on page ii.
Index for July through August begins on page viii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The first Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the first Bulletin of the succeeding semiannual period, respectively.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 263A.—Capitalization and Inclusion in Inventory of Certain Expenses

Taxpayers are informed that, in the future, the Service and Treasury Department may provide guidance under which the automatic approval procedures will no longer apply to a particular method of accounting, effective for applications filed after such change is announced. See Notice 2003-59, page 429.

Section 409(p).—Qualifications for Tax Credit Employee Stock Ownership Plans — Prohibited Allocations of Securities in an S-Corporation

T.D. 9081

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Prohibited Allocations of Securities in an S Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

SUMMARY: This document contains temporary regulations concerning requirements for employee stock ownership plans (ESOPs) holding stock of Subchapter S corporations. The temporary regulations provide guidance on identifying disqualified persons and determining whether a plan year is a nonallocation year under section 409(p) and on the definition of synthetic equity under section 409(p)(5). These temporary regulations would generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of the temporary regulations also serves as the text of the proposed regulations (REG–129709–03) set forth in the notice of proposed rulemaking on this subject on page 506 of this issue of the Bulletin.

DATES: *Effective Date:* These regulations are effective July 21, 2003.

Applicability Date: These temporary regulations are applicable with respect to plan years ending after October 20, 2003.

FOR FURTHER INFORMATION CONTACT: John T. Ricotta at (202) 622–6060 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

Section 4975(e)(7) provides that an ESOP is a defined contribution plan that is designed to invest primarily in qualifying employer securities and that is either a stock bonus plan which is qualified, or a stock bonus plan and money purchase pension plan both of which are qualified, under section 401(a). Section 4975(e)(7) authorizes the Secretary to issue regulations imposing additional requirements for ESOPs (see §54.4975–11 of the Excise Tax Regulations). A plan is not treated as an ESOP under the Code unless it meets the following requirements, to the extent applicable: section 409(h) (relating to participants' right to receive employer securities; put options); section 409(o) (relating to participants' distribution rights and payment requirements); section 409(n) (relating to securities received in transactions to which section 1042 applies); section 409(p) (relating to prohibited allocations of securities in an S corporation); section 664(g) (relating to qualified gratuitous transfers of qualified employer securities); and section 409(e) (relating to participants' voting rights if the employer has a registration-type class of securities). As authorized by section 4975(e)(7), additional requirements are imposed under §54.4975–11.

Section 1361(b)(1)(D) provides that a Subchapter S corporation (S corporation) may not have more than one class of stock. Section 1361(b)(1)(B) provides that an S corporation may not have as a shareholder a person that is not an estate, a trust described in section 1361(c)(2), an organization described in section 1361(c)(6), or an individual. In 1996, section 1361(c)(6) was amended to permit a qualified plan under section 401(a) to be a shareholder in an S corporation. Section 1316(a) of the Small Business Job Protection Act of 1996 (SBJPA) (110 Stat. 1755) (1996).

Section 511(a)(1) imposes a tax on the unrelated business taxable income (as defined in section 512(a)) of organizations described in section 511(a)(2), which include plans that qualify under section 401(a). Section 512(e)(1) provides that if an organization described in section 1361(c)(6) holds stock in an S corporation, the interest is treated as an interest in an unrelated trade or business and, notwithstanding the organization's general tax-exempt status, all items of income, loss, or deduction taken into account under section 1366(a) and any gain or loss on the disposition of the stock in the S corporation are taken into account in computing the unrelated business taxable income of the organization. In 1997, section 512(e) was amended to provide that section 512(e) does not apply to employer securities (within the meaning of section 409(l)) held by an ESOP described in section 4975(e)(7). Section 1523 of the Taxpayer Relief Act of 1997 (TRA '97) (111 Stat. 788) (1997). Accordingly, S corporation income allocable to stock held by an ESOP is not subject to regular income or unrelated business income tax, but S corporation income allocable to stock held by any other qualified plan or tax-exempt entity under section 501(c)(3) is subject to the unrelated business income tax under section 511.

Congress became aware that the tax exemption for earnings on S corporation stock held by an ESOP may lead to inappropriate tax deferral or avoidance in some cases. In order to address these concerns, Congress enacted section 409(p) as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 38) (2001). Section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. As explained in the legislative history:

> The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporation owners to obtain inappropriate tax deferral or avoidance.
>
> Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage

under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

H. R. Rep. No. 107–51, part 1, at 100 (2001).

Section 409(p)(1) requires an ESOP holding employer securities consisting of stock in an S corporation to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person, as defined in section 409(p).[1]

Section 409(p)(3)(A) provides that a "nonallocation year" includes any plan year during which the ownership of the S corporation is so concentrated among disqualified persons that they own at least 50 percent of its shares. Section 409(p)(3)(B) provides that, in determining the shares owned by an individual for purposes of section 409(p)(3)(A), the attribution rules of section 318(a) apply, with certain exceptions, and the individual is treated as owning his or her deemed-owned ESOP shares.

Under section 409(p)(4)(C)(i), the term *deemed-owned shares* includes, with respect to any person, the stock in the S corporation constituting employer securities of an ESOP which is allocated to that person under the ESOP, and that person's share of the stock in the S corporation which is held by the ESOP but which is not allocated to participants under the ESOP. Suspense account stock is deemed to be allocated to participants in the same proportion as the most recent plan allocation.

Section 409(p)(4) provides, in general, that whether someone is a "disqualified person" depends on a person's ownership of deemed-owned shares of S corporation stock held by an ESOP (deemed-owned ESOP shares). Section 409(p)(4) provides, in general, that a "disqualified person" means any person whose deemed-owned ESOP shares are at least 10 percent of the number of deemed-owned ESOP or for whom the aggregate number of deemed-owned ESOP shares of such person and the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares.

The determination of whether someone is a disqualified person and whether a plan year is a nonallocation year is made without regard to "synthetic equity" attributable to that person and is also made separately taking into account synthetic equity. Synthetic equity is a general classification unique to section 409(p). The provisions relating to synthetic equity do not modify the rules relating to S corporations, *e.g.*, the circumstances in which options or similar interests are treated as creating a second class of stock. H.R. Conf. Rep. No. 107–84, at 102 n.52. Under section 409(p)(6)(C), synthetic equity is defined as:

> any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.

Under the rules for the treatment of synthetic equity at section 409(p)(5), if a person owns synthetic equity in an S corporation, then the shares of stock in such corporation on which such synthetic equity is based are generally treated as outstanding stock in such corporation, and as deemed-owned shares of such person, if such treatment of synthetic equity results either in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Accordingly, if a person is treated as a disqualified person or a year is treated as a nonallocation year without regard to synthetic equity, then the inclusion of synthetic equity as outstanding stock does not cause the person to fail to be treated as a disqualified person or the year to fail to be treated as a nonallocation year.

Section 409(p)(7)(A) authorizes the Secretary to prescribe such regulations as may be necessary to carry out the purposes of section 409(p). As indicated by the legislative history above, section 409(p) is intended to limit the tax benefits of ESOPs maintained by S corporations unless the ESOP provides meaningful benefits to rank-and-file employees. See H.R. Rep. No. 107–51, part 1, at 100 (2001). Section 409(p)(7)(B) provides that the Secretary may, by regulation or other guidance of general applicability, provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). "For example, this might apply if more than 10 independent businesses are combined in an S corporation owned by an ESOP in order to take advantage of the income tax treatment of S corporations owned by an ESOP." H.R. Conf. Rep. No. 107–84, at 277 (2001).

Under section 656 of EGTRRA, section 409(p) is effective for plan years ending after March 14, 2001, except for those ESOPs eligible for a delayed effective date applicable to certain ESOPs that were established on or before March 14, 2001. See Rev. Rul. 2003–6, 2003–3 I.R.B. 286.

Section 4979A imposes a 50 percent excise tax in certain cases, including an allocation of employer securities that is prohibited by section 409(p), the ownership of any synthetic equity by a disqualified person during a nonallocation year, and the occurrence of the first nonallocation year of an ESOP, as described in section 4979A(e)(2)(C).

Explanation of Provisions

Overview

Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. Under the statute as amended, an ESOP is still permitted to hold S corporation stock, provided that the ESOP benefits a sufficiently broad-based group of employees.

These temporary regulations reflect the statutory language under section 409(p)(1) prohibiting an accrual or allocation in a nonallocation year, but do not provide additional guidance on what constitutes a prohibited accrual or allocation. It is expected that this issue will be addressed in additional regulations.

An ESOP has a nonallocation year for any plan year during which, at any

[1] This definition is different from the definition of disqualified person for purposes of section 4975.

time, disqualified persons hold at least 50 percent of the outstanding shares of stock in the S corporation or 50 percent of the outstanding shares of stock and synthetic equity in the S corporation. These temporary regulations provide guidance on the rules applicable for this purpose. In addition, pursuant to section 409(p)(7)(B), these temporary regulations authorize the Commissioner to provide that a nonallocation year exists in any year in which the principal purpose of the ownership structure is avoidance or evasion of section 409(p). These temporary regulations also provide guidance on identification of disqualified persons.

Synthetic Equity

As discussed above, disqualified persons and nonallocation years are identified both with and without synthetic equity. Section 409(p) defines synthetic equity very broadly. Synthetic equity includes restricted stock, rights to acquire stock in the corporation, such as stock options or warrants, and other similar interests. It also includes payments denominated in share value, including a phantom stock unit, stock appreciation right, or similar interest.

In addition, under these temporary regulations, synthetic equity includes two other categories of interests or payments: nonqualified deferred compensation (even though it is neither payable in, nor calculated by reference to, stock in the S corporation) and rights to acquire interests in certain related entities. In each case, treatment of these interests as synthetic equity is necessary to carry out the Congressional purpose of section 409(p) of limiting the tax deferral opportunities provided by an S corporation ESOP to those situations in which the benefits of the ESOP ownership are available, at a minimum, to a broad group of rank-and-file employees who have the opportunity to be the primary beneficiaries of the growth of the business through the ESOP. Unless these interests are treated as synthetic equity, the benefits associated with ownership of an interest in an S Corporation by means of the ESOP could be concentrated in a small group, and diverted away from the rank-and-file employees, through use of these interests. In this respect, these interests have the same effect as stock appreciation rights payable in cash, which are explicitly included in synthetic equity by statute.

Nonqualified Deferred Compensation as Synthetic Equity

Since the addition of section 409(p), arrangements have been promoted to taxpayers in which an S corporation that is either entirely or substantially owned by an ESOP is used to shelter the income of an active business while the profits of the business are primarily provided for certain management employees of the business through various obligations to make future payments to the employees. Typically in these arrangements, the obligation to make future payments to the management employees suppresses the value of the company's stock that is allocated to rank-and-file employees through the ESOP, depriving them of the opportunity to be the primary beneficiaries of the growth of the business through the ESOP.

For example, under some of these arrangements, the owners of the operating company establish a management company and the operating company agrees to pay management fees equal to substantially all (or most) of the profits of the operating company. The management company agrees to provide future compensation to certain executives or other employees of the operating company or the management company in an amount equal to substantially all of the profits of the management company. Finally, the management company elects to be treated as an S corporation and transfers all, or a substantial portion, of its stock to an ESOP established to cover rank-and-file employees. Under this arrangement, the operating company claims a deduction for the fees paid to the management corporation. The management corporation in turn retains these fees to satisfy its obligations to pay future compensation. Although the stock of the management corporation is owned by the ESOP, the ownership interest held for rank-and-file employees through the ESOP has a substantially reduced value. Rather than being a mechanism for the transfer of not only ownership, but also the rights associated with ownership, to the employees of the S corporation, the ESOP is used as part of a structure designed to shelter profits that will be paid as future compensation for a small group of executives or management employees.

These temporary regulations treat nonqualified deferred compensation provided by the S corporation or certain related entities as synthetic equity, including deferred compensation that is neither payable in stock of the S corporation nor calculated by reference to stock of the S corporation. S Corporations that do not maintain ESOPs typically do not provide nonqualified deferred compensation to owners. By treating nonqualified deferred compensation provided by the S corporation (or certain related entities) as synthetic equity, these temporary regulations address ownership structures that are designed to avoid or evade section 409(p) and provide guidance allowing individuals to determine when these interests result in a failure to comply with section 409(p). Nonqualified deferred compensation is appropriately characterized as synthetic equity because it functions similarly to other forms of synthetic equity by diverting value away from shareholders, thereby reducing the value of the S corporation and diminishing the ESOP's interest in the value that, absent the nonqualified deferred compensation, would be reflected in the shares of the S corporation held by the ESOP. This effect occurs even if the nonqualified deferred compensation is a fixed dollar amount, and even if such deferred compensation is not payable in stock of the S corporation or measured by reference to that stock (directly, such as a stock appreciation right payable in cash, or less directly, such as percentage of the future profits of the S corporation).

Right to Acquire Assets as Synthetic Equity

Under these temporary regulations, rights to acquire stock or other similar interests in a related entity are treated as synthetic equity if the ownership of such interests in the related entity is the only significant asset of the S corporation and the S corporation is the only significant holder of stock (or other similar interests) of the related entity. For this purpose, related entities are entities in which the S corporation holds an interest and with respect to which income is passed through to the S corporation. These rights are properly treated as synthetic equity because they provide the holders of these rights with an opportunity to benefit from the S corporation ESOP structure that is comparable to the opportunity provided through synthetic equity issued directly by the S corporation. Taking rights to acquire stock or other similar interests in a related entity into account as synthetic equity provides a method for identifying situations in which the interests in the S corporation (and its assets) have, directly or indirectly, become concentrated in a manner that should result in a nonallocation year under section 409(p).

These temporary regulations provide that synthetic equity does not include rights to acquire goods or services at fair market value in the ordinary course of business. The temporary regulations do not address, at this time, rights to acquire other assets of the S Corporation or assets of the related entity or other related entities. This absence should not be interpreted as a conclusion that a right to acquire these other assets cannot be synthetic equity. It may be appropriate to treat the right to acquire assets of the S Corporation, other than its interest in a related entity (such as its ownership of a manufacturing plant), as synthetic equity. It may also be appropriate to treat rights to acquire assets held by the related entity as synthetic equity.

The temporary regulations also do not address rights to acquire interests in related entities if the ownership of such interests in the related entity is not the only significant asset of the S corporation or the S corporation is not the only significant holder of stock (or other similar interests) of the related entity. Rights to acquire interests in other related entities is reserved because, for example, it may be appropriate in cases in which a related entity is not the only significant asset of the S Corporation to treat as synthetic equity only a portion of the value of the rights to acquire stock or other similar interests in the related entity.

The IRS and Treasury intend to issue additional regulations providing guidance on the definition of synthetic equity on a number of issues, including issues identified as reserved in these temporary regulations. For example, the IRS and Treasury intend to issue additional guidance relating to rights to acquire interests in other related entities and rights to acquire assets of an S corporation or related entity. The additional regulations are expected to address the treatment of these interests, including how any such interests treated as synthetic equity should be converted into shares of synthetic equity in the S corporation and whether such conversion should take into account the extent to which income of the related entity is allocated to a shareholder that is subject to regular income tax or unrelated trade or business income tax. These items are reserved in order to allow for additional consideration of these issues, including consideration of comments on the proposed regulations accompanying these regulations. The additional regulations are expected to be issued in conjunction with guidance on prohibited accruals or allocations to disqualified persons in a nonallocation year, which is also identified as reserved in these temporary regulations.

In the meantime, these temporary regulations provide an anti-abuse provision treating acquisition rights as synthetic equity in certain situations. Specifically, this treatment applies to an option or right to acquire assets of the S corporation, or a related person, that is part of a structure that provides rights to the holder comparable to the rights provided by arrangements identified as synthetic equity under these temporary regulations and in which the principal purpose of the structure is the avoidance or evasion of section 409(p). In addition, the temporary regulations delegate authority to the Commissioner to provide, through revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter), that synthetic equity includes a right to acquire stock or other similar interests in a related entity in cases in which the S corporation's interest in the related entity is not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity.

Rights to Acquire Shares of Stock That are Issued and Outstanding

The definition of synthetic equity provides that rights to acquire shares in an S corporation with respect to shares that are, at all times during the period when such rights are effective, both issued and outstanding and held by persons other than the ESOP, S corporation, or a related entity are not synthetic equity. These arrangements include, for example, rights of first refusal held by one shareholder in the S corporation with respect to the shares of another taxable shareholder (*i.e.*, shares held outside the tax-exempt structure created by the ESOP). However, in certain limited cases, a disqualified person who has the right to acquire such issued and outstanding stock is treated as owning the stock if such treatment results in a nonallocation year.

Conversion of Synthetic Equity

Synthetic equity that is determined by reference to shares of S corporation stock is treated as the corresponding number of shares of stock. Synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity is converted into an equivalent number of shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)). The value of any other synthetic equity interest, such as fixed dollar nonqualified deferred compensation, is converted into an equivalent number of shares of stock in the S corporation based on the present value of the interest or right to nonqualified deferred compensation (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)) and the fair market value of the S corporation shares on the determination date (with both values determined as of any reasonable date during the plan year).

Identification of Disqualified Persons

Under these temporary regulations, a person is a disqualified person based either on deemed-owned ESOP shares or deemed-owned ESOP shares combined with synthetic equity. Whether there is a nonallocation year is then determined by taking into account the holdings of all disqualified persons, first based only on outstanding shares of stock of the corporation and then based on outstanding shares of stock and synthetic equity of the corporation. In accordance with the last sentence of section 409(p)(5), synthetic equity cannot result in a person who is treated as a disqualified person for a year, or a year that is treated as a nonallocation year, not being so treated. In addition, these temporary regulations provide that, in any year in which the Commissioner provides that a nonallocation year occurs because the principal purpose of the ownership structure of the S corporation is an avoidance or evasion of section 409(p), the Commissioner may also treat any individual as a disqualified person.

As a result of the provisions of these temporary regulations relating to synthetic equity, employees who benefit from nonqualified deferred compensation arrangements or who hold rights to acquire interests in certain related entities will be treated as owning synthetic equity and may be treated as disqualified persons. As a result, certain plan years of the ESOP may be treated as nonallocation years. This result will not occur unless the aggregate interest held by disqualified persons — through synthetic equity, direct share ownership, and deemed-owned ESOP shares — constitutes at least half of the value of the outstanding stock and synthetic equity of the S corporation.

Effective Date

In the case of an ESOP holding stock in an S corporation that is eligible for the delayed effective date under section 656(d)(2) of EGTRRA applicable to certain ESOPs established on or before March 14, 2001, these temporary regulations do not apply until plan years beginning on or after January 1, 2005. For an ESOP to which the delayed effective date is not applicable, these temporary regulations are applicable with respect to plan years ending after October 20, 2003. The temporary regulations permit S corporations to avoid having nonqualified deferred compensation treated as synthetic equity under paragraph (f)(2)(iv) of these temporary regulations by distributing the deferred compensation by July 21, 2004.

Request for Comments in Proposed Regulations and Future Guidance

See the preamble of the cross-reference notice of proposed rulemaking published elsewhere in this issue of the Bulletin which asks for comments with respect to issues raised by S corporation ESOPs.

Special Analysis

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. For the applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6) refer to the Special Analyses section of the preamble to the cross-referencing notice of proposed rulemaking published in this issue of the Bulletin. Pursuant to section 7805(f) of the Internal Revenue Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact.

Drafting Information

The principal author of these regulations is John T. Ricotta of theOffice of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.409(p)–1T is also issued under 26 U.S.C. 409(p)(7). * * *

Par. 2. Section 1.409(p)–1T is added to read as follows:

§1.409(p)–1T Prohibited allocation of securities in an S corporation (temporary).

(a) *Organization of this section*. Sections 409(p) and 4979A apply if a nonallocation year occurs in an employee stock ownership plan (ESOP), as defined in section 4975(e)(7), that holds shares of stock of a Subchapter S corporation (S corporation) that are employer securities as defined in section 409(l). Paragraph (b) of this section sets forth the general rule under section 409(p)(1) and (2) prohibiting an allocation to a disqualified person in a nonallocation year. Paragraph (c) of this section sets forth rules under section 409(p)(3), (5), and (7) for determining whether a year is a nonallocation year, generally based on whether disqualified persons own at least 50 percent of the shares of the S corporation, either taking into account only the outstanding shares of the S corporation (including shares held by the ESOP) or taking into account both the outstanding shares and synthetic equity of the S corporation. Paragraphs (d), (e), and (f) of this section contain definitions of a disqualified person under section 409(p)(4) and (5), deemed-owned ESOP shares under section 409(p)(4)(C), and synthetic equity under section 409(p)(6)(C).

(b) *Prohibited accruals in a nonallocation year*—(1) *General rule*. An ESOP holding employer securities consisting of stock in an S corporation must provide that no portion of the assets of the plan attributable to (or allocable in lieu of) such employer securities may, during a nonallocation year, accrue (or be allocated directly or indirectly under any plan of the employer meeting the requirements of section 401(a)) for the benefit of any disqualified person.

(2) *Additional rules*. [Reserved]

(c) *Nonallocation year* — (1) *Definition generally*. A *nonallocation year* means a plan year of an ESOP during which, at any time, the ESOP holds any employer securities that are shares of an S corporation and either —

(i) Disqualified persons own at least 50 percent of the number of outstanding shares of stock in the S corporation (including deemed-owned ESOP shares), or

(ii) Disqualified persons own at least 50 percent of the aggregate number of outstanding shares of stock (including deemed-owned ESOP shares) and synthetic equity in the S corporation.

(2) *Attribution rules*. For purposes of this paragraph (c), the rules of section 318(a) apply to determine ownership of shares in the S corporation (including deemed-owned ESOP shares) and synthetic equity. However, for this purpose, section 318(a)(4) (relating to options to

acquire stock) is disregarded and, in applying section 318(a)(1), the members of an individual's family include members of the individual's family under paragraph (d)(2) of this section. In addition, an individual is treated as owning deemed-owned ESOP shares of that individual notwithstanding the employee trust exception in section 318(a)(2)(B)(i). If the attribution rules in paragraph (f)(1) of this section apply, then the rules of paragraph (f)(1) of this section are applied before the rules of this paragraph (c)(2).

(3) *Special rule for avoidance or evasion*. Under section 409(p)(7)(B), the Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(B) of this chapter), may provide that a nonallocation year occurs in any case in which the principal purpose of the ownership structure of an S corporation constitutes an avoidance or evasion of section 409(p). For any year that is a nonallocation year under this paragraph (c)(3), the Commissioner may treat any person as a disqualified person.

(4) *Special rule for certain stock rights*. (i) For purposes of paragraph (c)(1) of this section, a person is treated as owning stock that the person has a right to acquire if, at all times during the period when such rights are effective, the stock that the person has the right to acquire is both issued and outstanding and is held by persons other than the ESOP, the S corporation, or a related entity (as defined in paragraph (f)(2)(iii)(A)(*4*) of this section).

(ii) This paragraph (c)(4) applies only if treating persons as owning the shares described in paragraph (c)(4)(i) results in a nonallocation year. This paragraph (c)(4) does not apply to a right that, under §1.1361–1(l)(2)(iii) or (l)(4)(iii)(C), would not be taken into account in determining if an S corporation has a second class of stock, and does not apply for purposes of determining ownership of deemed-owned ESOP shares or whether an interest constitutes synthetic equity (see the last sentence of paragraph (f)(2)(i)).

(d) *Disqualified persons* — (1) *General rule*. A *disqualified person* is any person for whom —

(i) The number of such person's deemed-owned ESOP shares is at least 10 percent of the number of deemed-owned ESOP shares of the S corporation;

(ii) The aggregate number of such person's deemed-owned ESOP shares and synthetic equity shares is at least 10 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation;

(iii) The aggregate number of deemed-owned ESOP shares of such person and of the members of such person's family is at least 20 percent of the number of deemed-owned ESOP shares of the S corporation; or

(iv) The aggregate number of deemed-owned ESOP shares and synthetic equity shares of such person and of the members of such person's family is at least 20 percent of the aggregate number of deemed-owned ESOP and synthetic equity shares of the S corporation.

(2) *Treatment of family members; definition*. (i) Each member of the family of any person who is a disqualified person under paragraph (d)(1)(iii) or (iv) of this section is a disqualified person. *Member of the family* means, with respect to an individual —

(A) the spouse of the individual;

(B) an ancestor or lineal descendant of the individual or the individual's spouse;

(C) a brother or sister of the individual or of the individual's spouse and any lineal descendant of the brother or sister; and

(D) the spouse of any individual described in paragraph (d)(2)(ii) or (iii) of this section.

(ii) A spouse of an individual who is legally separated from such individual under a decree of divorce or separate maintenance is not treated as such individual's spouse for purposes of this paragraph (d)(2).

(3) *Special rule for certain nonallocation years*. See paragraph (c)(3) of this section (relating to avoidance or evasion of section 409(p)) for a special rule permitting any person to be treated as a disqualified person in certain nonallocation years.

(e) *Deemed-owned ESOP shares*. A person is treated as owning his or her deemed-owned ESOP shares. *Deemed-owned ESOP shares* mean, with respect to any person —

(1) Any shares of stock in the S corporation constituting employer securities that are allocated to such person's account under the ESOP; and

(2) Such person's share of the stock in the S corporation that is held by the ESOP but is not allocated to the account of any participant or beneficiary (with such person's share to be determined in the same proportion as the most recent stock allocation under the ESOP).

(f) *Synthetic equity* — (1) *Ownership of synthetic equity*. For purposes of section 409(p) and this section, synthetic equity is treated as owned by a person in the same manner as stock is treated as owned by a person, directly or under the rules of section 318(a)(2) and (3). *Synthetic equity* means the rights described in paragraph (f)(2) of this section.

(2) *Synthetic equity*— (i) *Rights to acquire stock of the S corporation. Synthetic equity* includes any stock option, warrant, restricted stock, deferred issuance stock right, stock appreciation right payable in stock, or similar interest or right that gives the holder the right to acquire or receive stock of the S corporation in the future. Rights to acquire stock in an S corporation with respect to stock that is, at all times during the period when such rights are effective, both issued and outstanding and held by persons other than the ESOP, the S corporation, or a related entity, are not synthetic equity (but see paragraph (c)(4) of this section).

(ii) *Special rule for certain stock rights. Synthetic equity* also includes a right to a future payment (payable in cash or any other form other than stock of the S corporation) from an S corporation that is based on the value of the stock of the S corporation or appreciation in such value, such as a stock appreciation right with respect to stock of an S corporation that is payable in cash or a phantom stock unit with respect to stock of an S corporation that is payable in cash.

(iii) *Rights to acquire assets of an S corporation or related entity*—(A) *Rights to acquire interests in a related entity* — (*1*) *Treatment as synthetic equity. Synthetic equity* includes a right to acquire stock or other similar interests in a related entity that is described in this paragraph (f)(2)(iii)(A).

(*2*) Significant interests. *Synthetic equity* includes a right to acquire stock or other similar interests in a related entity if such interests in the related entity are the only significant asset of the S corporation and the S corporation is the only significant owner of the related entity. Whether an asset is the only significant asset of the

S corporation or the S corporation is the only significant owner of the related entity depends on the relevant facts and circumstances.

(*3*) *Rights to acquire interests in other related entities*. [Reserved]

(*4*) *Related entity*. For purposes of this section, *related entity* means any entity in which the S corporation holds an interest and which is a partnership, a trust, an eligible entity that is disregarded as an entity that is separate from its owner under §301.7701–3 of this chapter or a Qualified Subchapter S Subsidiary under section 1361(b)(3).

(B) *Rights to acquire assets of an S corporation or related entity other than rights to acquire stock or similar interests in a related entity*—(*1*) *General rule*. [Reserved]

(*2*) *Exception for rights to acquire goods or services in ordinary course of business*. *Synthetic equity* does not include rights to acquire goods or services at fair market value in the ordinary course of business.

(C) *Authority to provide guidance*. The Commissioner, in revenue rulings, notices, and other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(B) of this chapter), may provide that *synthetic equity* includes a right to acquire stock or other similar interests in a related entity in cases in which such interests in the related entity are not the only significant asset of the S corporation or the S corporation is not the only significant owner of the related entity if necessary to carry out the purposes of section 409(p).

(D) *Synthetic equity includes comparable rights*. An option or right to acquire assets of the S corporation or another person is treated as synthetic equity if such option or right is part of a structure that provides rights to the holder comparable to the rights provided by arrangements identified as synthetic equity under this paragraph (f)(2)(iii) and the principal purpose of the structure is the avoidance or evasion of section 409(p).

(iv) *Special rule for nonqualified deferred compensation*. *Synthetic equity* also includes any remuneration for services rendered to the S corporation, or a related entity, to which section 404(a)(5) applies (including remuneration for which a deduction would be permitted under section 404(a)(5) if separate accounts were maintained), any right to receive property (to which section 83 applies) in a future year for the performance of services to an S corporation, or related entity, and any transfer of property (to which section 83 applies) in connection with the performance of services to an S corporation, or a related entity, to the extent that the property is not substantially vested within the meaning of §1.83–3(i) by the end of the plan year in which transferred. *Synthetic equity* also includes any other remuneration for services rendered to the S corporation, or a related entity, under a plan, or method or arrangement, deferring the receipt of compensation to a date that is after the 15th day of the 3rd calendar month after the end of the entity's taxable year in which the related services are rendered, other than a plan that is an eligible retirement plan within the meaning of section 402(c)(7)(B).

(3) *No overlap among shares of deemed-owned ESOP shares or synthetic equity*. Synthetic equity under this paragraph (f) does not include shares that are deemed-owned ESOP shares. In addition, synthetic equity under a specific subparagraph of this paragraph (f) does not include anything that is synthetic equity under a preceding subparagraph of this paragraph (f).

(4) *Number of synthetic shares*— (i) *Synthetic equity determined by reference to S corporation shares*. In the case of synthetic equity that is determined by reference to shares of stock of the S corporation, the person who is entitled to the synthetic equity is treated as owning the corresponding number of shares of stock. For example, if a corporation grants an employee of an S corporation an option to purchase 100 shares of the corporation's stock, the employee is the deemed owner of 100 synthetic equity shares of the stock of the corporation.

(ii) *Synthetic equity determined by reference to shares in a related entity*. In the case of synthetic equity that is determined by reference to shares of stock (or similar interests) in a related entity, the person who is entitled to the synthetic equity is treated as owning shares of stock of the S corporation with the same aggregate value as the number of shares of stock (or similar interests) of the related entity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)).

(iii) *Other synthetic equity*. In the case of any other synthetic equity, the person who is entitled to the synthetic equity is treated as owning a number of shares of stock in the S corporation equal to the present value of the synthetic equity (with such value determined without regard to any lapse restriction as defined at §1.83–3(i)) divided by the fair market value of a share of the S corporation's stock as of the same date. For purposes of this paragraph (f)(4)(iii), the number of shares of S corporation is permitted to be determined as of the first day of the ESOP's plan year, or any other reasonable determination date or dates during a plan year that is consistently used by the corporation for this purpose for all persons. The number of shares of synthetic equity treated as owned for any period from a determination date through the date immediately preceding the next following determination date is the number of shares treated as owned on the first day of that period.

(g) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. (i) *Facts*. Corporation X is a calendar year S corporation that maintains an ESOP. X has a single class of common stock, of which there are a total of 1,200 shares outstanding. X has no synthetic equity. In 2006, individual A, who is not an employee of X (and is not related to any employee of X), owns 100 shares directly, individual B owns 100 shares directly, and the remaining 1,000 shares are owned by an ESOP maintained by X for its employees. The ESOP's 1,000 shares are allocated to the accounts of individuals who are employees of X (none of whom are related), as set forth in columns 1 and 2 in the following table:

1 Shareholders	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Disqualified Person
B	330	33%	Yes
C	145	14.5%	Yes
D	75	7.5%	No
E	30	3%	No
F	20	2%	No
Other participants	400 (none exceed 10 shares)	1% or less	No

(ii) *Conclusion with respect to disqualified persons*. As shown in column 4 in the table above, individuals B and C are disqualified persons for 2006 under paragraph (d)(1) of this section because each owns at least 10% of X's deemed-owned ESOP shares.

(iii) *Conclusion with respect to nonallocation year*. However, 2006 is not a nonallocation year under section 409(p) because disqualified persons do not own at least 50% of X's outstanding shares (the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, plus C's 145 deemed-owned ESOP shares equal only 47.9% of the 1,200 outstanding shares of X).

Example 2. (i) *Facts*. The facts are the same as in *Example 1*, except that, as shown in column 4 of the table below, individual E has an option to acquire 500 shares of the common stock of X from X:

1 Shareholders	2 Deemed-Owned ESOP Shares (total of 1,000)	3 Percentage Deemed-Owned ESOP Shares	4 Synthetic Equity (500)	5 Percentage Deemed-Owned ESOP plus Synthetic Equity Shares (total of 1,500)	6 Disqualified Person
B	330	33%		22%	Yes (cols. 3 and 5)
C	145	14.5%		9.7%	Yes (col. 3)
D	75	7.5%		5%	No
E	30	3%	500	35.3%	Yes (col. 5)
F	20	2%		1.3%	No
Other participants	400 (none exceed 10 shares)	1% or less		under 1%	No

(ii) *Conclusion with respect to disqualified persons*. E's option constitutes 500 shares of synthetic equity. Accordingly, as shown in column 6 in the table above, individuals B, C, and E are disqualified persons for 2006 because each owns at least 10% of X's deemed-owned ESOP shares or X's total deemed-owned ESOP and synthetic equity shares.

(iii) *Conclusion with respect to nonallocation year*. The 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, E's 30 deemed-owned ESOP shares, plus E's 500 synthetic equity shares equals 65% of the 1,700 outstanding and synthetic equity shares of X. Thus, 2006 is a nonallocation year for X's ESOP under section 409(p) because disqualified persons own at least 50% of X's total shares of outstanding stock and synthetic equity. In addition, independent of the preceding conclusion, 2006 would be a nonallocation year because disqualified persons own at least 50% of X's outstanding shares because the 100 shares owned directly by B, B's 330 deemed-owned ESOP shares, C's 145 deemed-owned ESOP shares, plus E's 30 deemed-owned ESOP shares equals 50.4% of the 1,200 outstanding shares of X.

(h) *Effective date* —(1) *General effective dates*. Except as provided in paragraph (h)(2) of this section, section 409(p) applies for plan years ending after March 14, 2001, and this section applies for plan years ending after October 20, 2003, except that paragraph (f)(2)(iv) of this section is disregarded with respect to nonqualified deferred compensation that is distributed on or before July 21, 2004.

(2) *Certain ESOPs established on or before March 14, 2001*. If an ESOP holding stock in an S corporation was established on or before March 14, 2001, and the election under section 1362(a) with respect to that S Corporation was in effect on March 14, 2001, section 409(p) and this section apply for plan years beginning on or after January 1, 2005.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

Approved July 9, 2003.

Pamela F. Olson,
Assistant Secretary of Treasury (Tax Policy).

(Filed by the Office of the Federal Register on July 18, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 21, 2003, 68 F.R. 42970)

Section 446.—General Rule for Methods of Accounting

26 CFR 1.446-1: General rule for methods of accounting.

Taxpayers are informed that, in the future, the Service and Treasury Department may provide guidance under which the automatic approval procedures will no longer apply to a particular method of accounting, effective for applications filed after such change is announced. See Notice 2003-59, page 429.

Section 860.—Taxation of Residual Interests

For rules on the proper accounting for income from inducement fees, see section 1.446-6. See REG-162625-02, page 500.

Section 863.—Special Rules for Determining Source

Sourcing rule for inducement fees defined in section 1.446-6. See REG-162625-02, page 500.

Part III. Administrative, Procedural, and Miscellaneous

Weighted Average Interest Rate Update

Notice 2003–58

Sections 412(b)(5)(B) and 412(l)(7)(C)(i) of the Internal Revenue Code provide that the interest rates used to calculate current liability for purposes of determining the full funding limitation under § 412(c)(7) and the required contribution under § 412(l) must be within a permissible range around the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year.

Notice 88–73, 1988–2 C.B. 383, provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Code.

Section 417(e)(3)(A)(ii)(II) of the Code defines the applicable interest rate, which must be used for purposes of determining the minimum present value of a participant's benefit under § 417(e)(1) and (2), as the annual rate of interest on 30-year Treasury securities for the month before the date of distribution or such other time as the Secretary may by regulations prescribe. Section 1.417(e)–1(d)(3) of the Income Tax Regulations provides that the applicable interest rate for a month is the annual interest rate on 30-year Treasury securities as specified by the Commissioner for that month in revenue rulings, notices or other guidance published in the Internal Revenue Bulletin.

The rate of interest on 30-year Treasury Securities for July 2003 is 4.93 percent. Pursuant to Notice 2002–26, 2002–1 C.B. 743, the Service has determined this rate as the monthly average of the daily determination of yield on the 30-year Treasury bond maturing in February 2031.

Section 405 of the Job Creation and Worker Assistance Act of 2002 amended § 412(l)(7)(C) of the Code to provide that for plan years beginning in 2002 and 2003 the permissible range is extended to 120 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 110% Permissible Range	90% to 120% Permissible Range
August	2003	5.31	4.78 to 5.85	4.78 to 6.38

Drafting Information

The principal authors of this notice are Paul Stern and Tony Montanaro of the Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, please contact the Employee Plans' taxpayer assistance telephone service at 1–877–829–5500 (a toll-free number), between the hours of 8:00 a.m. and 6:30 p.m. Eastern time, Monday through Friday. Mr. Stern may be reached at 1–202–283–9703. Mr. Montanaro may be reached at 1–202–283–9714. The telephone numbers in two preceding sentences are not toll-free.

Simplified Service Cost Method; Simplified Production Method

Notice 2003–59

Notice 2003–36, 2003–23 I.R.B. 992, provides that after May 8, 2003, the Internal Revenue Service will not accept Forms 3115, *Application for Change in Accounting Method*, filed under the automatic consent procedures of Rev. Proc. 2002–9, 2002–1 C.B. 327, that request consent to change to either the simplified service cost method or the simplified production method for self-constructed assets under §§ 1.263A–1(h)(2)(i)(D) and 1.263A–2(b)(2)(i)(D) of the Income Tax Regulations. This notice informs taxpayers that the Service and Treasury Department have decided that a taxpayer will be permitted, after May 8, 2003, to timely file Forms 3115 to make these changes under Rev. Proc. 2002–9 for its most recent taxable year ending on or before May 8, 2003. To qualify under this notice, a taxpayer that wishes to file a Form 3115 on or after August 13, 2003, must do so under Rev. Proc. 2002–9 requesting to make a change for its most recent taxable year ending on or before May 8, 2003, and in addition to complying with the requirements of Rev. Proc. 2002–9, must include the following statement on top of the form: "Automatic Change Filed Under Notice 2003–59."

A taxpayer that has timely filed its original federal income tax return after May 8, 2003, but on or before September 12, 2003, for a taxable year ending on or before May 8, 2003, also may request automatic consent to make such a change by complying with Rev. Proc. 2002–9 and this notice. However, such a taxpayer is not subject to the filing requirements in section 6.02(3)(a) of Rev. Proc. 2002–9, provided that the taxpayer complies with the following filing requirements. The taxpayer must complete and file a Form 3115 in duplicate. The original must be attached to the taxpayer's amended federal income tax return for its most recent taxable year ending on or before May 8, 2003. This amended return must be filed no later than February 13, 2004. A copy of the Form 3115 must be filed with the national office (see section 6.02(6)(a) of Rev. Proc. 2002–9 for the address) no later than when the taxpayer's amended return is filed.

For taxable years ending after May 8, 2003, Forms 3115 to make these changes must be filed with the national office under Rev. Proc. 97–27, 97–1 C.B. 680.

In the future, if the Service and Treasury Department provide that the automatic consent procedures no longer apply for one or more methods of accounting for which taxpayers had been permitted to use the automatic consent procedures, such change may be effective for Forms 3115 filed after such change is announced. In such case, a taxpayer that has not filed a copy of Form 3115 with the national office by the time the change is announced would not be permitted to use the automatic consent procedures.

EFFECT ON OTHER DOCUMENTS

Notice 2003–36 is modified.

DRAFTING INFORMATION

The principal author of this notice is Scott H. Rabinowitz of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Mr. Rabinowitz at (202) 622–4970 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Retirement Plans; Cash or Deferred Arrangements Under Section 401(k) and Matching Contributions or Employee Contributions Under Section 401(m) Regulations

REG–108639–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that would provide guidance for certain retirement plans containing cash or deferred arrangements under section 401(k) and providing for matching contributions or employee contributions under section 401(m). These regulations affect sponsors of plans that contain cash or deferred arrangements or provide for employee or matching contributions, and participants in these plans. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for November 12, 2003, must be received by October 22, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–108639–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–108639–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, R. Lisa Mojiri-Azad or John T. Ricotta at (202) 622–6060 (not a toll-free number); concerning submissions and the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collections of information should be received by September 15, 2003. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collections of information in these proposed regulations are contained in §§1.401(k)–1(d)(3)(iii)(C), 1.401(k)–2(b)(3), 1.401(k)–3(d), 1.401(k)–3(f), 1.401(k)–3(g), 1.401(k)–4(d)(3), 1.401(m)–3(e), 1.401(m)–3(g) and 1.401(m)–3(h). The information required by §§1.401(k)–3(d), 1.401(k)–3(f), 1.401(k)–3(g), 1.401(m)–3(e), 1.401(m)–3(g) and 1.401(m)–3(h) is required by the IRS to comply with the requirements of sections 401(k)(12)(D) and 401(m)(11)(A)(ii) regarding notices that must be provided to eligible participants to apprize them of their rights and obligations under certain plans. This information will be used by participants to determine whether to participate in the plan, and by the IRS to confirm that the plan complies with applicable qualification requirements to avoid adverse tax consequences. The information required by §1.401(k)–4(d)(3) is required by the IRS to comply with the requirements of section 401(k)(11)(B)(iii)(II) regarding notices that must be provided to eligible participants to apprize them of their rights and obligations under certain plans. This information will be used by participants to determine whether to participate in the plan, and by the IRS to confirm that the plan complies with applicable qualification requirements to avoid adverse tax consequences. The information required by §1.401(k)–2(b)(3) will be used by employees to file their income tax returns and by the IRS to assess the correct amount of tax. The information provided under §1.40(k)–1(d)(3)(iii)(C) will be used by employers in determining whether to make hardship distributions to participants. The collections of information are mandatory. The respondents are businesses or other for-profit institutions, and nonprofit institutions.

Estimated total annual reporting burden: 26,500 hours.

The estimated annual burden per respondent is 1 hour, 10 minutes.

Estimated number of respondents: 22,500.

The estimated annual frequency of responses: On occasion.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains proposed new comprehensive regulations setting forth the requirements (including the nondiscrimination requirements) for cash or deferred arrangements under section 401(k) and for matching contributions and employee contributions under section 401(m) of the Internal Revenue Code (Code).

Comprehensive final regulations under sections 401(k) and 401(m) of the Code were last published in the **Federal Register** in T.D. 8357, 1991–2 C.B. 181, (published August 9, 1991) and T.D. 8376, 1991–2 C.B. 245, (published December 2, 1991) and amended by T.D. 8581, 1995–1 C.B. 54, published on December 22, 1994. Since 1994, many significant changes have been made to sections 401(k) and 401(m) by the Small Business Job Protection Act of 1996, Public Law 104–188 (110 Stat. 1755) (SBJPA), the Taxpayer Relief Act of 1997, Public Law 105–34 (111 Stat. 788) (TRA '97), and the Economic Growth and Tax Relief Reconciliation Act of 2001, Public Law 107–16 (115 Stat. 38) (EGTRRA).

The most substantial changes to the section 401(k) and section 401(m) provisions were made to the methodology for testing the amount of elective contributions, matching contributions, and employee contributions for nondiscrimination. Section 401(a)(4) prohibits discrimination in contribution or benefits in favor of highly compensated employees (within the meaning of section 414(q)) (HCEs). Section 401(k) provides a special nondiscrimination test for elective contributions under a cash or deferred arrangement that is part of a profit-sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan, called the actual deferral percentage (ADP) test. Section 401(m) provides a parallel test for matching contributions and employee contributions under a defined contribution plan, called the actual contribution percentage (ACP) test. These special nondiscrimination standards are provided in recognition of the fact that the amount of elective contributions and employee contributions (and corresponding matching contributions) is determined by the employee's utilization of the contribution opportunity offered under the plan. This is in contrast to the situation in other defined contribution plans where the amount of contributions is determined by the amount the employer decides to contribute.

Sections 401(k) and 401(m) provide alternative methods for satisfying the applicable nondiscrimination rules: a mathematical comparison and a number of design-based methods. The inherent variation in the amount of contributions among employees noted above, and the fact that the economic situation of HCEs may make them more likely to make elective or employee contributions, means that the usual nondiscrimination test under section 401(a)(4) — under which for each HCE with a contribution level there must be a specified number of nonhighly compensated employees (NHCEs) with equal or greater contributions — is not appropriate. Instead, average rates of contribution are used in the ADP and ACP tests (with a built-in differential permitted for HCEs) and minimum standards for nonelective or matching contributions are provided in the design-based alternatives.

Prior to the enactment of SBJPA, sections 401(k) and 401(m) provided only for mathematical comparison. Specifically, the ADP and ACP tests compare the average of the rates of contributions of the HCEs to the average of the rates of contributions of the NHCEs. For this purpose, the rate of contributions for an employee is the amount of contributions for an employee divided by the employee's compensation for the plan year. These tests are satisfied if the average rate of HCE contributions does not exceed 1.25 times the average rate of contributions of the NHCEs. Alternatively, these tests are satisfied if the average rate of HCE contributions does not exceed the average rate of contributions of the NHCEs by more than 2 percentage points and is no more than 2 times the average rate of contributions of the NHCEs. To the extent that these tests are not satisfied, the statute provides for correction through distribution to HCEs (or forfeiture of nonvested matching contributions) or, to the extent provided in regulations, recharacterization of elective contributions as after-tax contributions. In addition, to the extent provided in regulations, nonelective contributions can be made to NHCEs and elective contributions and certain matching contributions can be moved between the ADP and ACP tests, in order the reduce the discrepancy between the average rates of contribution for the HCEs and the NHCEs.

SBJPA added design-based alternative methods of satisfying the ADP and ACP tests. Under these methods, if a plan meets certain contribution and notice requirements, the plan is deemed to satisfy the nondiscrimination rules without regard to actual utilization of the contribution opportunity offered under the plan. These regulations reflect this change and the other changes that were made to sections 401(k) and 401(m) under SBJPA, TRA '97 and EGTRRA since the issuance of final regulations under those sections.

SBJPA made the following significant changes affecting section 401(k) and section 401(m) plans:

- The ADP test and ACP test were amended to allow the use of prior year data for NHCEs.

- The method of distributing to correct failures of the ADP test or ACP test was changed to require distribution to the HCEs with the highest contributions.

- Tax-exempt organizations and Indian tribal governments are permitted to maintain section 401(k) plans.

- A safe harbor alternative to the ADP test and ACP test was introduced in order to provide a design-based method to satisfy the nondiscrimination tests.

- The SIMPLE 401(k) plan (an alternative design-based method to satisfy the nondiscrimination tests for small employers that corresponds to the provisions of section 408(p) for SIMPLE IRA plans by providing for smaller contributions) was added.

- A special testing option was provided for plans that permit participation before employees meet the minimum age and service requirements, in order to encourage employers to permit employees to start participating sooner.

TRA '97 made the following significant changes affecting section 401(k) and section 401(m) plans:

- State and local governmental plans are treated as automatically satisfying the ADP and ACP tests.
- Matching contributions for self-employed individuals are no longer treated as elective contributions.

EGTRRA made the following significant changes affecting section 401(k) and section 401(m) plans:

- Catch-up contributions were added to provide for additional elective contributions for participants age 50 or older.
- The Secretary was directed to change the section 401(k) regulations to shorten the period of time that an employee is stopped from making elective contributions under the safe harbor rules for hardship distributions.
- Beginning in 2006, section 401(k) plans will be permitted to allow employees to designate their elective contributions as "Roth contributions" that will be subject to taxation under the rules applicable to Roth IRAs under section 408A.
- Section 401(k) plans using the design-based safe harbor and providing no additional contributions in a year are exempted from the top-heavy rules of section 416.
- Distributions from section 401(k) plans are permitted upon "severance from employment" rather than "separation from service."
- The multiple use test specified in section 401(m)(9) is repealed.
- Faster vesting is required for matching contributions
- Matching contributions are taken into account in satisfying the top-heavy requirements of section 416.

In addition, since publication of the final regulations, a number of items of guidance affecting section 401(k) and section 401(m) plans addressing these statutory changes and other items have been issued by the IRS, including:

- Notice 97–2, 1997–1 C.B. 348, provided initial guidance on prior year ADP and ACP testing and guidance on correction of excess contributions and excess aggregate contributions, including distribution to the HCEs with the highest contributions.
- Rev. Proc. 97–9, 1997–1 C.B. 624, provided model amendments for SIMPLE 401(k) plans.
- Notice 98–1, 1998–1 C.B. 327, provided additional guidance on prior year testing issues.
- Notice 98–52, 1998–2 C.B. 632, and Notice 2000–3, 2000–1 C.B. 413, provided guidance on safe harbor section 401(k) plans.
- Rev. Rul. 2000–8, 2000–1 C.B. 617, addressed the use of automatic enrollment features in section 401(k) plans.
- Notice 2001–56, 2001–2 C.B. 277, and Notice 2002–4, 2002–2 I.R.B. 298, provided initial guidance related to the changes made by EGTRRA.

These items of guidance are incorporated into these proposed regulations with some modifications and the proposed regulations have been reorganized as indicated in the tables of contents at proposed §§1.401(k)–0 and 1.401(m)–0. Treasury and the IRS believe that a single restatement of the section 401(k) and section 401(m) rules serves the interests of plan sponsors, third-party administrators, plan participants, and plan beneficiaries.

The process of reviewing and integrating all existing administrative guidance under sections 401(k) and 401(m) has led Treasury and the IRS to reconsider certain rules and to propose certain changes in those rules. To the extent practicable, this preamble identifies the substantive changes and explains the underlying analysis. In many cases, the changes will clarify or simplify existing guidance and will reduce plan administrative burdens.

Treasury and the IRS appreciate the fact that plan sponsors and third-party administrators have developed systems and practices in the application of existing administrative guidance to the design and operation of section 401(k) and section 401(m) plans. In many cases, the details of these systems and practices have been determined through a plan sponsor's or administrator's interpretation of specific terms in existing guidance or, where no guidance has been provided, through a plan sponsor's or administrator's best legal and practical judgment. As a result, these systems and practices may differ from administrator to administrator, from sponsor to sponsor, or from plan to plan.

Treasury and the IRS also recognize that certain of the substantive changes in these proposed regulations will require changes in plan design or plan operation. However, the proposed regulations are not otherwise intended to require significant changes in plan systems and practices that were developed under existing guidance and that conform to the requirements of sections 401(k) and 401(m). Therefore, Treasury and the IRS specifically request that plan sponsors and third-party administrators comment on points where the proposed regulations might have the unintended effect of requiring a change to plan systems or practices so that Treasury and the IRS can further evaluate whether such a change is in fact appropriate or whether Treasury and the IRS should instead make an adjustment in the final regulations.

Explanation of Provisions

1. Rules Applicable to All Cash or Deferred Arrangements

Section 401(k)(1) provides that a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan will not fail to qualify under section 401(a) merely because it contains a qualified cash or deferred arrangement. Section 1.401(k)–1 would set forth the general definition of a cash or deferred arrangement (CODA), the additional requirements that a CODA must satisfy in order to be a qualified CODA, and the treatment of contributions made under a qualified or nonqualified CODA.

As under the existing final regulations, a CODA is defined as an arrangement under which employees can make a cash or deferred election with respect to contributions to, or accruals or benefits under, a plan intended to satisfy the requirements of section 401(a). A cash or deferred election is any direct or indirect election by an employee (or modification of an earlier election) to have the employer either: 1) provide an amount to the employee in the form of cash or some other taxable benefit that is not currently available; or 2) contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation. A cash or deferred election can include a salary reduction agreement, but the specific reference to a salary reduction agreement has been eliminated as unnecessary. In addition, the proposed regulations would incorporate prior guidance on automatic enrollment, and thus would reflect the fact that a CODA can specify that the default that applies in the absence of an affirmative election by an employee can be a contribution to a trust, as described in Rev. Rul. 2000–8.[1]

The proposed regulations would continue to provide that the definition of a CODA excludes contributions that are treated as after-tax employee contributions at the time of the contribution and contributions made pursuant to certain one-time irrevocable elections, but would also specify that a CODA does not include an arrangement under which dividends paid to an ESOP are either distributed to a participant or reinvested in employer securities in the ESOP pursuant to an election by the participant or beneficiary under section 404(k)(2)(A)(iii) as added by EGTRRA.

The proposed regulations would also specify that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made. Thus, a contribution made in anticipation of an employee's election is not treated as an elective contribution. Similarly, the regulations would provide that a contribution is made pursuant to a cash or deferred election only if the contribution is made after the employee's performance of services which relate to the compensation that, but for the election, would be paid to the employee. (If the payment of compensation would have preceded the performance of services, a contribution made no earlier than the date the compensation would have been paid, but for the election, is also treated as made pursuant to a cash or deferred election). Accordingly, amounts contributed in anticipation of future performance of services generally would not be treated as elective contributions under section 401(k). These restrictions on the timing of contributions are consistent with the fundamental premise of elective contributions, that these are contributions that are paid to the plan as a result of an employee election not to receive those amounts in cash. Moreover, ensuring that contributions are made after the employee's election furthers plan administrability.

The deductibility of these prefunded elective contributions (as well as prefunded matching contributions) for the taxable year in which the contribution was made was addressed in Notice 2002–48, 2002–29 I.R.B.139. In that notice, the IRS indicated that it was reviewing issues other than the deductibility of prefunded contributions but, pending additional guidance, would not challenge the deductibility of the contributions provided actual payment is made during the taxable year for which the deduction is claimed and the amount deducted does not exceed the applicable limit under section 404(a)(3)(A)(i). After considering this issue, the IRS and Treasury have concluded that the prefunding of elective contributions and matching contributions is inconsistent with sections 401(k) and 401(m). Thus, under these proposed regulations, an employer would not be able to prefund elective contributions to accelerate the deduction for elective contributions. Once these regulations are finalized, employer contributions made under the facts in Notice 2002–48 would no longer be permitted to be taken into account under the ADP test or the ACP test and would not satisfy any plan requirement to provide elective contributions or matching contributions.

2. Qualified CODAs

A. General rules relating to qualified CODAs

Elective contributions under a qualified CODA are treated as employer contributions and generally are not included in the employee's gross income at the time the cash would have been received (but for the cash or deferred election), or at the time contributed to the plan. Elective contributions under a qualified CODA are included in the employee's gross income however, if the contributions are in excess of the section 402(g) limit for a year, are designated Roth contributions (under section 402A, effective for tax years beginning after December 31, 2005) or are recharacterized as after-tax contributions as part of a correction of an ADP test failure.

A CODA is not qualified unless it is part of a profit sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan and provides for an election between contributions to the plan or payments directly in cash. In addition, a CODA is not qualified unless it meets the following requirements: 1) the elective contributions under the CODA satisfy either the ADP test set forth in section 401(k)(3) or one of the design-based alternatives in section 401(k)(11) or (12); 2) elective contributions under the CODA are nonforfeitable at all times; 3) elective contributions are distributable only on the occurrence of certain events, including attainment of age 59½, hardship, death, disability, severance from employment, or termination of the plan; 4) the group of employees eligible to participate in the CODA satisfies the coverage requirements of section 410(b)(1); 5) no other benefit (other than matching contributions or another specified benefit) is conditioned, directly or indirectly, upon the employee's making or not making elective contributions under the CODA; and 6) no more than 1 year of service is required for eligibility to elect to make a cash or deferred election.

Subject to certain exceptions, state and local governmental plans are not allowed

[1] The Department of Labor has advised Treasury and the IRS that, under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), fiduciaries of a plan must ensure that the plan is administered prudently and solely in the interest of plan participants and beneficiaries. While ERISA section 404(c) may serve to relieve certain fiduciaries from liability when participants or beneficiaries exercise control over the assets in their individual accounts, the Department of Labor has taken the position that a participant or beneficiary will not be considered to have exercised control when the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary. See 29 CFR 2550.404c–1 and 57 FR 46924.

to include a qualified CODA. Plans sponsored by Indian tribal governments and rural cooperatives are allowed to include a qualified CODA.

B. Nondiscrimination rules applicable to CODAs

As under the existing regulations, the proposed regulations would provide that the special nondiscrimination standards set forth in section 401(k) are the exclusive means by which a qualified CODA can satisfy the nondiscrimination in amount of contribution requirement of section 401(a)(4). These special nondiscrimination standards now include: the ADP test, the ADP safe harbor and the SIMPLE 401(k) plan. Pursuant to section 401(k)(3)(G), a state or local governmental plan is deemed to satisfy the ADP test.

In addition, as under existing regulations, the plan must satisfy the requirements of §1.401(a)(4)–4 with respect to the nondiscriminatory availability of benefits, rights and features, including the availability of each level of elective contributions, matching contributions, and after-tax employee contributions. The provisions of the existing regulations related to compliance with sections 410(b) and 401(a)(4) would be revised to clarify the relationship of the rules under sections 410(b) and 401(a)(4) to the requirements for a qualified CODA and to remove redundant provisions. Except as provided below, however, these rules are substantively unchanged.

These proposed regulations are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of section 401(k). Further, these nondiscrimination requirements are part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of section 401(k) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(k), if a principal purpose of the changes was to achieve such a result.

C. Aggregation and disaggregation of plans

The proposed regulations would consolidate the rules in the existing regulations regarding identification of CODAs and plans for purposes of demonstrating compliance with the requirements of section 401(k). As under the existing regulations, all CODAs included in a plan are treated as a single CODA for purposes of applying the nondiscrimination tests. For this purpose, a plan is generally defined by reference to §1.410(b)–7(a) and (b) after application of the mandatory disaggregation rules of §1.410(b)–7(c) (other than the mandatory disaggregation of section 401(k) and section 401(m) plans) and permissive aggregation rules of §1.410(b)–7(d), as modified under these regulations. For example, if a plan covers collectively bargained employees and noncollectively bargained employees, the elective contributions for the separate groups of employees must be subject to separate nondiscrimination tests under section 401(k). The proposed regulations would also retain the special rules in the existing regulations that permit the aggregation of certain employees in different collective bargaining units and the prohibition on restructuring under §1.401(a)(4)–9(c).

The proposed regulations would change the treatment of a CODA under a plan which includes an ESOP. Section 1.410(b)–7(c)(2) provides that the portion of a plan that is an ESOP and the portion that is not an ESOP are treated as separate plans for purposes of section 410(b) (except as provided in §54.4975–11(e)). Accordingly, under the existing regulations, such a plan must apply two separate nondiscrimination tests: one for elective contributions going into the ESOP portion (and invested in employer stock) and one for elective contributions going in the non-ESOP portion of the plan. The additional testing results in increased expense and administrative difficulty for the plan and creates the possibility that the ESOP portion or the non-ESOP portion may fail the ADP test or ACP test because HCEs may be more or less likely to invest in employer securities than NHCEs.

Since the issuance of the existing regulations, the use of an ESOP as the employer stock fund in a section 401(k) plan has become much more widespread. In light of this development, the proposed regulations would eliminate disaggregation of the ESOP and non-ESOP portions of a single section 414(l) plan for purposes of ADP testing. The same rule would apply for ACP testing under section 401(m). In addition, the proposed regulations would provide that, for purposes of applying the ADP test or the ACP test, an employer could permissively aggregate two section 414(l) plans, one that is an ESOP and one that is not.

However, the exception to mandatory disaggregation of ESOPs from non-ESOPs set forth in these proposed regulations would not apply for purposes of satisfying section 410(b). Accordingly, the group of eligible employees under the ESOP and non-ESOP portions of the plan must still separately satisfy the requirements of sections 401(a)(4) and 410(b).

The proposed regulations would also provide that a single testing method must apply to all CODAs under a plan. This has the effect of restricting an employer's ability to aggregate section 414(l) plans for purposes of section 410(b), if those plans apply inconsistent testing methods. For example, a plan that applies the ADP test of section 401(k)(3) may not be aggregated with a plan that uses the ADP safe harbor of section 401(k)(12) for purposes of section 410(b).

D. Restrictions on withdrawals

As discussed above, a qualified CODA must provide that elective contributions may only be distributed after certain events, including hardship and severance from employment. EGTRRA amended section 401(k)(2)(B)(i)(I) by replacing "separation from service" with "severance from employment." This change eliminated the "same desk rule" as a standard for distributions under section 401(k) plans.

In addition, EGTRRA amended Code section 401(k)(10) by deleting disposition by a corporation of substantially all of the assets of a trade or business and disposition of a corporation's interest in a subsidiary, leaving termination of the plan as the only distributable event described in section 401(k)(10). Finally, EGTRRA directs the Secretary of the Treasury to revise the regulations relating to distributions under section 401(k)(2)(B)(i)(IV) to provide that the period during which an employee is prohibited from making elective and employee contributions following a hardship distribution is 6 months (instead of 12 months as required under §1.401(k)–1(d)(2)(iv)(B)(*4*) of the existing regulations).[2]

Notice 2001–56 and Notice 2002–4 provided guidance on these EGTRRA changes to the distribution rules for elective contributions. That guidance is incorporated in these proposed regulations. In connection with the change to severance from employment, comments are requested on whether a change in status from employee to leased employee described in section 414(n) should be treated as a severance from employment that would permit a distribution to be made. In addition, the proposed regulations do not include reference to "retirement" (included in the existing regulation) as an event allowing distribution because retirement is not listed in the statute, and is subsumed by severance from employment.

In addition to the statutory changes, the rules relating to hardship distributions have been reorganized in order to clarify certain ambiguities, including the relationship between the generally applicable rules, employee representations, and the safe harbors provided under the existing regulations. The existing regulations set forth two basic requirements (*i.e.*, the employee has an immediate and heavy financial need and the distribution is necessary to satisfy that need) followed by safe harbor provisions. The proposed regulations would retain those basic requirements, but would clarify that each safe harbor is separately applicable to each basic requirement. In addition, the proposed regulations would provide that an employee representation used for purposes of determining that a distribution is necessary to satisfy an immediate and heavy financial need must provide that the need cannot reasonably be relieved by any available distribution or nontaxable plan loan (even if the distribution or loan would not be sufficient to satisfy the financial need), but need not provide that a loan from a commercial source will be taken if no such loan in an amount sufficient to satisfy the need is available on reasonable commercial terms.

The proposed regulations would also modify the existing regulations to add other types of defined contribution plans to the list of plans that an employer may maintain after the termination of the plan that contains the qualified CODA while still providing for distribution of elective contributions upon plan termination. The list of such plans has been expanded to include not only an ESOP and a SEP, but also a SIMPLE IRA plan, a plan or contract that satisfies section 403(b) and a section 457 plan.

Finally, under the existing regulations, a plan that receives a plan-to-plan transfer that includes elective contributions, QNECs, or QMACs, must provide that the restrictions on withdrawals continue after the transfer. These proposed regulations would also make explicit a requirement that the transferor plan will fail to comply with the restrictions on withdrawals if it transfers elective contributions, QNECs, or QMACs to a plan that does not provide for these restrictions. However, a transferor plan will not fail to comply with this requirement if it reasonably concludes that the transferee plan provides for restrictions on withdrawals. What constitutes a basis for a reasonable conclusion would be comparable to the rules related to acceptance of rollover distributions. See §1.401(a)(31)–1, A–14.

E. Other rules for qualified CODAs

The proposed regulations would generally retain the additional requirements set forth in the existing regulations that a CODA must satisfy in order to be qualified, with some modifications. First, in order to be a qualified CODA the arrangement must provide an employee with an effective opportunity to elect to receive the amount in cash no less than once during the plan year. Under the proposed regulations, whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time before the cash is currently available during which an election may be made, and any other conditions on elections.

The proposed regulations would also provide that a plan must provide for satisfaction of one of the specific nondiscrimination alternatives described in section 401(k). As with the existing regulations, the plan may accomplish this by incorporating by reference the ADP test of section 401(k)(3) and the regulations under proposed §1.401(k)–2, if that is the nondiscrimination alternative being used. If, with respect to the nondiscrimination alternative being used there are optional choices, the plan must provide which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3) must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. The safe harbors are intended to provide employees with a minimum threshold in benefits in exchange for easier compliance for the plan sponsor. It would be inconsistent with this approach to providing benefits to allow an employer to deliver smaller benefits to NHCEs and revert to testing.

The proposed regulations would retain the existing rules relating to the section 401(k)(4)(A) prohibition on having benefits (other than a match) contingent on making or not making an elective contribution. However, the proposed regulations would specify that, in the case of a benefit that requires an amount to be withheld from an employee's pay, an employer is not violating the section 401(k)(4)(A)

[2] Under section 402(c), as amended by the IRS Restructuring and Reform Act of 1998, Public Law 105–206 (112 Stat. 685), and EGTRRA, a hardship distribution is not an eligible rollover distribution. While the change affects distributions from a section 401(k) plan, there is no specific reference to the change in these proposed regulations because these regulations are under sections 401(k) and 401(m).

contingent benefit rule merely because the CODA restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes). In addition, these proposed regulations also reflect the amendment to section 416(c)(2)(A) under which matching contributions can be taken into account for purposes of satisfying the top-heavy minimum contribution requirement without violating the prohibition on making benefits contingent on making or not making elective contributions.

To reflect the amendment of section 401(k)(4)(B) by SBJPA to allow tax exempt organizations to maintain section 401(k) plans, the proposed regulations would also eliminate the provision prohibiting a tax-exempt employer from adopting a section 401(k) plan.

As under the existing final regulations, these proposed regulations would provide that a partnership is permitted to maintain a CODA, and individual partners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to common-law employees. This rule has been extended to sole proprietors. The provisions of these regulations also reflect the enactment of section 402(g)(8) (initially section 402(g)(9) as enacted by TRA '97) providing that matching contributions with respect to partners and sole proprietors are no longer treated as elective contributions.

3. Nonqualified CODAs

The proposed regulations would generally retain the rules in the existing regulations applicable to a nonqualified CODA (*i.e.*, a CODA that fails one or more of the applicable requirements to be a qualified CODA). Because elective contributions under such an arrangement are not entitled to the constructive receipt relief set forth in section 402(e)(3), the contributions are currently taxable to the employee. In addition, the plan to which such contributions are made must satisfy any nondiscrimination requirements that would otherwise apply under section 401(a)(4).

4. The Actual Deferral Percentage (ADP) Test

A. General rules relating to the ADP test

Section 1.401(k)–2 sets forth the rules for a CODA that is applying the ADP test contained in section 401(k)(3). Under the ADP test, the percentage of compensation deferred for the eligible HCEs is compared annually to the percentage of compensation deferred for eligible NHCEs, and if certain limits are exceeded by the HCEs, corrective action must be taken by the plan. Correction can be made through the distribution of excess contributions, the recharacterization of excess contributions, or the contribution of additional employer contributions.

Section 401(k)(3)(A), as amended by SBJPA, generally provides for the use of prior year data in determining the ADP of NHCEs, while current year data is used for HCEs. This testing option is referred to as the prior year testing method. Alternatively, a plan may provide for the use of current year data for determining the ADPs for both NHCEs and HCEs, which is known as the current year testing method. The proposed regulations would use the term applicable year to describe the year for which the ADP is determined for the NHCEs.

Section 401(k)(3)(F), as added by SBJPA, provides that a plan benefitting otherwise excludable employees and that, pursuant to section 410(b)(4)(B), is being treated as two separate plans for purposes of section 410(b), is permitted to disregard NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). Thus, the proposed regulations would permit such a plan to perform the ADP test by comparing the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A). The proposed regulations treat this rule as permissive. Accordingly, the new statutory provision does not eliminate the existing testing option under which a plan benefitting otherwise excludable employees is disaggregated into separate plans where the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

B. Elective contributions used in the ADP test

The proposed regulations would generally follow the existing regulations in defining which elective contributions are reflected in the ADP test and which ones are not. The proposed regulations would reflect the rule contained in the regulations under section 414(v), under which catch-up contributions that are in excess of a statutory limit or an employer-provided limit are not taken into account under the ADP test. See §1.414(v). In addition, the proposed regulations would incorporate the rule in §1.402(g)–1 that provides excess deferrals that are distributed are still taken into account under the ADP test (with the exception of deferrals made by NHCEs that were in violation of section 401(a)(30)). The proposed regulations retain the rule that elective contributions must be paid to the trust within 12 months after the end of the plan year. However, for plans subject to Title I of ERISA, contributions must be paid to the trust much sooner in order to satisfy the Department of Labor's regulations relating to when elective contributions become plan assets.

Section 401(k)(3) provides that the actual deferral ratio (ADR) of an HCE who is eligible to participate in 2 or more CODAs of the same employer is calculated by treating all CODAs in which the employee is eligible to participate as one CODA. The existing regulations implement this rule by aggregating the elective contributions of such an HCE for all plan years that end with or within a single calendar year. This can yield an inappropriate result if the plan years are different, because more than 12 months of elective contributions could be included in an employee's ADR. These proposed regulations would modify this rule to provide that the ADR for each HCE participating in more than one CODA is determined by aggregating the HCE's elective contributions that are within the plan year of the CODA being tested. In addition, the definition of period of participation for purposes of determining compensation would be modified to take into account periods of participation under another plan where the elective contributions must be aggregated for an HCE. As a result, even in the case of plans with different plan years, each of the employer's CODAs will use 12 months of elective contributions and 12 months of compensation in determining the ADR for an HCE who participates in multiple arrangements.

The proposed regulations would retain the rule in the existing regulations that provides that the HCE aggregation of elective contributions under CODAs does not apply where the CODAs are within plans that cannot be aggregated under §1.410(b)–7(d), but only after applying the modifications to the section 410(b) aggregation and disaggregation rules for section 401(k) plans provided in the proposed regulations. The non-application of the HCE aggregation rule would have less significance in light of the change described above relating to the elimination of the required disaggregation of ESOP and non-ESOP plans. In addition, the proposed regulations would clarify that, in determining whether two plans could be aggregated for this purpose, the prohibition on aggregating plans with CODAs that apply inconsistent testing methods set forth under these proposed regulations and the section 410(b) prohibition on aggregating plans that have different plan years would not apply.

C. Additional employer contributions used in the ADP test

The proposed regulations would generally retain the rules in the existing regulations permitting a plan to take qualified nonelective contributions or qualified matching contributions (*i.e.*, nonelective or matching contributions that satisfy the vesting and distribution limitations of section 401(k)(2)(B) and (C)) into account under the ADP test, except as described below. Thus, an employer whose CODA has failed the ADP test can correct this failure by making additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for its NHCEs. The proposed regulations would no longer describe such contributions as being treated as elective contributions under the arrangement, but would nonetheless permit such contributions to be taken into account under the ADP test.

As under the existing regulations, these proposed regulations would provide that QNECs must satisfy four requirements in addition to the vesting and distribution rules described above before they can be taken into account under the ADP test: 1) The amount of nonelective contributions, including the QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 2) the nonelective contributions, excluding the QNECs that are used under the ADP test or the ACP test, must satisfy section 401(a)(4); 3) the plan to which the QNEC or QMAC is made must be a plan that can be aggregated with the plan maintaining the CODA; and 4) the QNECs or QMACs must not be contingent on the performance of services after the allocation date and must be contributed within 12 months after the end of the plan year within which the contribution is to be allocated.[3] Thus, in the case of a plan using prior year ADP testing, any QNECs that are to be allocated to the NHCEs for the prior plan year must be contributed before the last day of the current plan year in order to be taken into account.

Some plans provide a correction mechanism for a failed ADP test that targets QNECs to certain NHCEs in order to reduce the total contributions to NHCEs under the correction. Under the method that minimizes the total QNECs allocated to NHCEs under the correction, the employer makes a QNEC to the extent permitted by the section 415 limits to the NHCE with the lowest compensation during the year in order to raise that NHCE's ADR. If the plan still fails to pass the ADP test, the employer continues expanding the group of NHCEs who receive QNECs to the next lowest-paid NHCE until the ADP test is satisfied. By using this bottom-up leveling technique, the employer can pass the ADP test by contributing small amounts of money to NHCEs who have very low compensation for the plan year (for example, an employee who terminated employment in early January with $300 of compensation). This is because of the fact that the ADP test is based on an unweighted average of ADRs and a small dollar (but high percentage of compensation) contribution to a terminated or other partial-year employee has a larger impact on the ADP test than a more significant contribution to a full-year employee.

The IRS and Treasury have been concerned that, by using these types of techniques, employers may pass the ADP test by making high percentage QNECs to a small number of employees with low compensation rather than providing contributions to a broader group of NHCEs. In addition, the legislative history to EGTRRA expresses Congressional intent that the Secretary of the Treasury will use his existing authority to address situations where qualified nonelective contributions are targeted to certain participants with lower compensation in order to increase the ADP of the NHCEs. (See EGTRRA Conference Report, H.R. Conf. Rep. 107–84, 240).

Accordingly, the proposed regulations would add a new requirement that a QNEC must satisfy in order to be taken into account under the ADP test. This requirement, designed to limit the use of targeted QNECs, would generally treat a plan as providing impermissibly targeted QNECs if less than half of all NHCEs are receiving QNECs and would also treat a QNEC as impermissibly targeted if the contribution is more than double the QNECs other nonhighly compensated employees are receiving, when expressed as a percentage of compensation. However, QNECs that do not exceed 5% of compensation are never treated as targeted and would always satisfy the new requirement.

This restriction on targeting QNECs would be implemented in the proposed regulations by providing that a QNEC that exceeds 5% of compensation could be taken into account for the ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's representative contribution rate. The plan's representative contribution rate would be defined as the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or the lowest contribution

[3] With respect to this timing requirement, it should be noted that in order to be taken into account for purposes of section 415(c) for a limitation year, the contributions will need to be made no later than 30 days after the end of the section 404(a)(6) period applicable to the taxable year with or within which the limitation year ends.

rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater). For purposes of determining an NHCE's contribution rate, the employee's qualified nonelective contributions and the qualified matching contributions taken into account under the ADP test for the plan year are added together and the sum is divided by the employee's compensation for the same period. The proposed regulations under section 401(m) would provide parallel restrictions on QNECs taken into account in ACP testing, and a QNEC cannot be taken into account under both the ADP and ACP test (including for purposes of determining the representative contribution rate). As discussed more fully below, the proposed regulations would also have a limitation on targeting matching contributions, which would limit the extent to which QMACs can be targeted as a means of avoiding the restrictions on targeted QNECs.

The proposed regulations would also implement a prohibition against double counting of QNECs that was set forth in Notice 98–1. Generally, QNECs used in an ADP or ACP test, used to satisfy the safe harbor under section 401(k), or under a SIMPLE 401(k) plan can not be used again to demonstrate compliance with another test under section 401(k)(3) or 401(m)(2). For example, double counting could arise when QNECs on behalf of NHCEs are used to determine the ADP under current year testing in year 1 and then, if the employer elected prior year testing, are used again in year 2 to determine the ADP of NHCEs. However, unlike Notice 98–1, these proposed regulations would not contain the additional limitations on double counting elective contributions or matching contributions that were moved between the ADP and ACP tests.

D. Correction

Section 401(k)(8)(C), as amended by the SBJPA, provides that, for purposes of correcting a plan's failure to meet the nondiscrimination requirements of section 401(k)(3), distribution of excess contributions is made on the basis of the amount of the contributions by, or on behalf of, each HCE. The proposed regulations would implement this correction procedure in the same manner as set forth in Notice 97–2. Thus, the total amount of excess contributions is determined using the rules under the existing final regulations (*i.e.*, based on high percentages). Then that total amount is apportioned among the HCEs by assigning the excess to be distributed first to those HCEs who have the greatest dollar amount of contributions taken into account under the ADP test (as opposed to the highest deferral percentage). If these amounts are distributed or recharacterized in accordance with these regulations, the plan complies with the ADP test for the plan year with no obligation to recalculate the ADP test.

The proposed regulations would provide a special rule for correcting through distribution of excess contributions in the case of an HCE who participates in multiple plans with CODAs. In that case, the proposed regulations would provide that, for purposes of determining which HCE will be apportioned a share of the total excess contributions to be distributed from a plan, all contributions in CODAs in which such an HCE participates are aggregated and the HCE with the highest dollar amount of contributions will be apportioned excess contributions first. However, only actual contributions under the plan undergoing correction — rather than all contributions taken into account in calculating the employee's ADR — may be distributed from a plan. If the high dollar HCE's actual contributions under the plan are insufficient to allow full correction, then the HCE with the next highest dollar amount of contributions is apportioned the remaining excess contributions. If additional correction is needed, this process is repeated until the excess contributions are completely apportioned. This correction mechanism is applied independently to each CODA in which the HCE participates. If correction is needed in more than one CODA, the ADRs of HCEs who have received corrective distributions under the other arrangements are not recalculated after correction in the first plan.

The proposed regulations would generally follow the rules in the existing regulations on the determination of net income attributable to excess contributions. The existing regulations provide for a reasonable determination of net income attributable to an excess contribution, but do not specify which contribution within the plan year is to be treated as the excess contribution to be distributed. This provision would be retained in the proposed regulations along with the existing alternative method of determining the net income, which approximates the result that would apply if the excess contribution is made on the first day of the plan year. However, to the extent the employee is or will be credited with allocable gain or loss on those excess contributions for the period after the end of the plan year (the gap period), the proposed regulations would now require that income be determined for that period. As under the existing regulations, the determination of the income for the gap period could be based on the income determined using the alternative method for the aggregate of the plan year and the gap period or using 10% of the income for the plan year (determined under the alternative method) for each month in the gap period.

The proposed regulations would permit the recharacterization of excess contributions in a manner that generally follows the existing regulations. However, the year the employee must include the recharacterized contribution in current income has been changed to match the year that the employee would have had to include the excess contribution in income, had it been distributed. Thus, if the recharacterized amount is less than $100, it is included in gross income in the year that it is recharacterized, rather than the year of the earliest elective contributions for the employee.

The proposed regulations would retain the rules in the existing regulations regarding the timing and tax treatment of distributions of excess contributions, coordination with the distribution of excess deferrals and the treatment of matches attributable to excess contributions.

E. Special rules relating to prior year testing

The proposed regulations would generally follow the rules set forth in Notice 98–1 regarding prior year testing, including the limitations on switching from current year testing to prior year testing. However, the proposed regulations would provide that a plan is permitted to be inconsistent between the choice of current year testing method and prior year testing method, as applied for ADP purposes and ACP purposes. In such a case, any movement of elective contributions or QMACs between the ADP and ACP tests (including recharacterization) would be prohibited.

The proposed regulations would generally incorporate the rules set forth in Notice 98–1 relating to plan coverage changes in the case of a plan using prior year testing. Thus, in the case of a plan that uses prior year testing and experiences a plan coverage change affecting more than 10% of the NHCEs, the ADP of the NHCEs would generally be determined as the weighted average of the ADP of the NHCEs of the plans in which the NHCEs participated in the prior year. The definition of plan coverage change includes changes in the group of eligible employees under a plan resulting from the establishment or amendment of a plan, a plan merger or spin-off or a change in the way plans are combined or separated under the section 410(b) rules. The definition under the proposed regulations would also include a reclassification of a substantial group of employees that has the same effect as amending the plan. These proposed regulations retain the rule that a plan that experiences coverage changes affecting 10% or less of the NHCEs disregards those changes in calculating the ADP for the NHCEs. Similarly, a plan that merely experiences a spin-off is not required to recalculate the ADP for the NHCEs.

5. Safe Harbor Section 401(k) Plans

Section 401(k)(12) provides a design-based safe harbor method under which a CODA is treated as satisfying the ADP test if the arrangement meets certain contribution and notice requirements. Section 1.401(k)–3 of these proposed regulations, which sets forth the requirements for these arrangements, generally follows the rules set forth in Notice 98–52 and Notice 2000–3. Thus, a plan satisfies the section 401(k) safe harbor if it makes specified QMACs for all eligible NHCEs. The matching contributions can be under a basic matching formula that provides for QMACs equal to 100% of the first 3% of elective contributions and 50% of the next 2% or an enhanced matching formula that is at least as generous in the aggregate, provided the rate of matching contributions under the enhanced matching formula does not increase as the employee's rate of elective contributions increases. In lieu of QMACs, the plan is permitted to provide QNECs equal to 3% of compensation for all eligible NHCEs. In addition, notice must be provided to each eligible employee, within a reasonable time before the beginning of the year, of their right to defer under the plan.

A plan using the safe harbor method must also comply with certain other requirements. Among these is the requirement in section 401(k)(12)(B)(ii) that provides that the rate of matching contribution for any elective contribution on the part of any HCE cannot exceed the rate of matching contribution that would apply to any NHCE with the same rate of elective contribution. Notice 98–52 advised that the general rules on aggregating contributions for HCEs eligible under more than one CODA would apply for this purpose. The IRS and Treasury have determined that such aggregation is not applicable under the ADP safe harbor. Accordingly, these proposed regulations would not require that elective or matching contributions on behalf of an HCE who is eligible to participate in more than one plan of the same employer be aggregated for purposes of the requirement of section 401(k)(12)(B)(ii). Thus, the rate of match for purposes of determining whether an HCE has a higher matching rate is based only on matching contributions with respect to elective contributions under the safe harbor plan. However, for an employer that uses the safe harbor method of satisfying the ACP test, the rule in Notice 98–52 is retained for applying the ACP safe harbor, with an exception for nonsimultaneous participation (as discussed in connection with the ACP safe harbor below).

These proposed regulations do not provide any rules relating to suspension of employee contributions under a plan that provides that safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions. Although Notice 2000–3 specifically permitted suspension of employee contributions in certain circumstances, the IRS and Treasury have determined that there are no limits on suspending employee contributions, provided that safe harbor matching contributions are made with respect to elective contributions. This is because the restrictions on suspension of elective contributions are sufficient to ensure an eligible NHCE can get the full matching contribution.

The proposed regulations do not include any exception to the requirements for safe harbor matching contributions with respect to catch-up contributions. Treasury and the IRS are aware that there are questions concerning the extent to which catch up contributions are required to be matched under a plan that provides for safe harbor matching contributions. Treasury and the IRS are interested in comments on the specific circumstances under which elective contributions by a NHCE to a safe harbor plan would be less than the amount required to be matched, *e.g.*, less than 5% of safe harbor compensation, but would be treated by the plan as catch-up contributions, and on the extent to which a safe harbor plan should be required to match catch-up contributions under such circumstances.

Section 401(k)(12)(D) contains a requirement that each eligible employee be provided with a notice of the employee's rights and obligations under the plan. These proposed regulations do not address the extent to which the notice can be provided through electronic media. As noted in the preamble to other regulations, the IRS and the Treasury Department are considering the extent to which the notice described in section 401(k)(12)(D), as well as other notices under the various Internal Revenue Code requirements relating to qualified retirement plans, can be provided electronically, taking into account the effect of the Electronic Signatures in Global and National Commerce Act (E-SIGN), Public Law 106–229 (114 Stat. 464 (2000)). The IRS and the Treasury Department anticipate issuing proposed regulations regarding these issues, and invite comments on these issues. Until those proposed regulations are issued, plan administrators and employers may continue to rely on the interim guidance in Q&A–7 of Notice 2000–3 on use of electronic media to satisfy the notice requirement in section 401(k)(12)(D).

These proposed regulations would clarify that a section 401(k) safe harbor plan must generally be adopted before the beginning of the plan year and be maintained throughout a full 12-month plan year. This requirement is consistent with the notion that the statute specifies a certain contribution level for nonhighly compensated employees in order to be deemed to pass the nondiscrimination requirements. If the contribution level is not maintained for a full 12-month year, the employer contributions made on behalf of nonhighly compensated employees should not support what could be a full year's contribution by the highly compensated employees.

The proposed regulations would adopt the exception to the requirement that a section 401(k) safe harbor plan be in place before the beginning of the plan year that was provided in Notice 2000–3. Under that option, an employer could adopt a section 401(k) safe harbor plan which has contingent non-elective contributions, provided the employer notifies employees of this contingent arrangement before the start of the year, amends the plan to provide the nonelective contributions no less than 30 days before the end of the year, and provides employees with a follow-up notice if the contribution will be made. Similarly, the proposed regulations would adopt the exception for a section 401(k) safe harbor plan that uses the matching contribution alternative. Under that exception, an employer can amend the plan to eliminate matching contributions with respect to future elective deferrals, provided that the matching contributions are made with respect to pre-amendment elective deferrals, employees are provided with notice of the change and the opportunity to change their elections, and the plan satisfies the ADP or ACP test for the plan year using the current year testing method.

The proposed regulations would recognize the practical difficulty in a 12-month requirement by following the rule in Notice 98–52 that allowed a short plan year in the first plan year and would allow a short plan year in certain other circumstances. Specifically, a section 401(k) safe harbor plan could have a short plan year in the year the plan terminates, if the plan termination is in connection with a merger or acquisition involving the employer, or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d). In addition, a section 401(k) safe harbor plan could have a short plan year if the plan terminates, the employer makes the safe harbor contributions for the short year, employees are provided notice of the change, and the plan passes the ADP test. Finally, a safe harbor plan could have a short plan year if it is preceded and followed by 12-month plan years as a section 401(k) safe harbor plan.

Under section 401(k)(12)(F), safe harbor contributions are permitted to be made to a plan other than the plan that contains the CODA. These proposed regulations reflect that rule and provide that the plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

Whether a contribution is taken into account for purposes of the safe harbor is determined in accordance with the rules regarding inclusion in ADP testing under proposed §1.401(k)–2(a). Thus, for example, a plan that provides for safe harbor matching contributions in 2006 need not provide for a matching contribution with respect to an elective contribution made during the first 2½ months of 2007 and attributable to service during 2006, unless that elective contribution is taken into account for 2006.

6. SIMPLE 401(k) Plans

Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the requirements of section 401(k)(3)(A)(ii) if the contribution, vesting, notice and exclusive plan requirements of section 401(k)(11) are satisfied. Section 1.401(k)–4 of these proposed regulations reflects the provisions of section 401(k)(11) in a manner that follows the positions reflected in the model amendments set forth in Rev. Proc. 97–9.

7. Matching Contributions and Employee Contributions.

Section 401(m)(2) sets forth a nondiscrimination test, the ACP test, with respect to matching contributions and employee contributions that is parallel to the nondiscrimination test for elective contributions set forth in section 401(k). Section 1.401(m)–1 of the proposed regulations would set forth this test in a manner that is consistent with the nondiscrimination test set forth in proposed §1.401(k)–1(b). Thus, satisfaction of the ACP test, the ACP safe harbor or the SIMPLE 401(k) provisions of the proposed regulations under section 401(k) are the exclusive means that matching contributions and employee contributions can use to satisfy the nondiscrimination in amount of contribution requirements of section 401(a)(4). An anti-abuse provision comparable to that provided in connection with the proposed regulations under section 401(k) limits the ability of an employer to make repeated changes in plan provisions or testing procedures that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(m), if a principal purpose of the changes was to achieve such a result.

These proposed regulations also include provisions regarding plan aggregation and disaggregation that are similar to those proposed for CODAs under section 401(k). For example, matching contributions made under the portion of a plan that is an ESOP and the portion of the same plan that is not an ESOP would not be disaggregated under these proposed regulations.

The definitions of matching contribution and employee contribution under §1.401(m)–1 of the proposed regulations would generally follow the definitions in the existing regulations. Thus, whether an employer contribution is on account of an elective deferral or employee contribution — and thus is a matching contribution — is determined based on all the relevant facts and circumstances. However, the proposed regulations would provide that a contribution would not be treated as a matching contribution on account of an elective deferral if it is contributed before the employee's performance of services with respect to which the elective deferral is made (or when the cash that is subject to the cash or deferred election would be currently available, if earlier) and an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution. Thus, under these regulations, an employer would not be able to prefund matching contributions to accelerate the deduction for those contributions and, as noted above with respect to the timing of elective contributions, employer contributions made under the facts in Notice 2002–48 would not be taken into account under the ACP test and would not satisfy any plan requirement to provide matching contributions.

8. ACP Test for Matching Contributions and Employee Contributions

Section 1.401(m)–2 of the proposed regulations would provide rules for the ACP test that generally parallel the rules applicable to the ADP test in proposed §1.401(k)–2. Thus, for example, the ACP test may be run by comparing the ACP for eligible HCEs for the current year with the ACP for eligible NHCEs for either the current plan year or the prior plan year. Similarly, the proposed regulations reflect the special ACP testing rule in section 401(m)(5)(C) for a plan that provides for early participation, comparable to the special ADP testing rule in section 401(k)(3)(F), as set forth in proposed §1.401(k)–2(a)(1)(iii).

The determination of the actual contribution ratio (ACR) for an eligible employee, and the contributions that are taken into account in determining that ACR, under these proposed regulations are comparable to the rules under the proposed section 401(k) regulations. Thus, for example, the ACR for an HCE who has matching contributions or employee contributions under two or more plans is determined by adding together matching contributions and employee contributions under all plans of the employer during the plan year of the plan being tested, in a manner comparable to that for determining the ADR of an HCE who participates in two or more CODAs.

The proposed regulations would retain the rule from the existing regulations under which a QMAC that is taken into account in the ADP test is excluded from the ACP test. In addition, the proposed regulations would continue to allow QNECs to be taken into account for ACP testing, but would provide essentially the same restrictions on targeting QNECs to a small number of NHCEs as is provided in proposed §1.401(k)–2. The only difference in the rules would be that the contribution percentages used to determine the lowest contribution percentage would be based on the sum of the QNECs and those matching contributions taken into account in the ACP test, rather than the sum of the QNECs and the QMACs taken into account under the ADP test. Because QNECs that do not exceed 5% are not subject to the limits on targeted QNECs under either the ADP test or the ACP test, an employer is permitted to take into account up to 10% in QNECs for an eligible NHCE, 5% in ADP testing and 5% in ACP testing, without regard to how many NHCEs receive QNECs.

In addition, to prevent an employer from using targeted matching contributions to circumvent the limitation on targeted QNECs, the proposed regulations would provide that matching contributions are not taken into account in the ACP test to the extent the matching rate for the contribution exceeds the greater of 100% and 2 times the representative matching rate. Paralleling the rule to limit targeted QNECs, the representative plan matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year (or the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year, if greater). For this purpose, the matching rate is the ratio of the matching contributions to the contributions that are being matched, and only NHCEs who make elective deferrals or employee contributions for the plan year are taken into account.

The proposed regulations would set limits on the use of elective contributions in the ACP test that are in addition to the rules in the existing regulations under which elective contributions may be taken into account for the ACP test only to the extent the plan satisfies the ADP test, determined by including such elective contributions in the ADP test. Under the new rule, the proposed regulations would provide that elective contributions under a plan that is not subject to the ADP test, such as a plan that uses the safe harbor method of section 401(k)(12) or a contract or arrangement subject to the requirements of section 403(b)(12)(A)(ii), may not be taken into account for the ACP test. In the absence of this prohibition, contributions that are not properly considered "excess" could be taken into account under the ACP test.

The provisions of these proposed regulations regarding correction of excess aggregate contributions, including allocation of excess aggregate contributions and determination of allocable income, would generally be consistent with the provisions of the proposed regulations under section 401(k). These proposed regulations continue the provisions of the current regulations regarding correction through distribution of vested matching contributions and forfeiture of unvested matching contributions. Similarly, the proposed regulations reflect the provisions of section 411(a)(3)(G) which permit the forfeiture of a matching contribution made with respect to an excess deferral, excess contribution, or excess aggregate contribution. This provision is necessary to allow forfeiture of matching contributions that would otherwise violate section 401(a)(4).

9. Safe Harbor Section 401(m) Plans

Section 401(m)(11) provides a design-based safe harbor method of satisfying the ACP test contained in section 401(m)(2). Under section 401(m)(11), a defined contribution plan is treated as satisfying the ACP test with respect to matching contributions if the plan satisfies the ADP safe harbor of section 401(k)(12) and matching contributions are not made with respect to employee contributions or elective contributions in excess of 6% of an employee's compensation. For a plan that satisfies the ADP safe harbor using a 3% nonelective contribution, two additional requirements that apply to a plan that satisfies the ADP safe harbor using matching contributions also apply: 1) the rate of an employer's matching contribution does not increase as the rate of employee contributions or elective deferrals increase; and 2) the matching contribution with respect to any HCE at any rate of employee contribution or elective deferral is not greater than with respect to any NHCE. In addition, the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals and employee contributions for a plan year cannot be greater than the ratio of matching contributions to elective deferrals or employee contributions that would apply with respect to any NHCE who contributes (as an elective deferral or employee contribution) the same percentage of safe harbor compensation for that plan year.

Section 1.401(m)–3 of these proposed regulations, which sets forth the requirements for these plans, would generally follow the rules set forth in Notice 98–52 and Notice 2000–3. These proposed regulations would clarify that, for purposes of determining whether an HCE has a higher rate of matching contributions than any NHCE, any NHCE who is an eligible employee under the safe harbor CODA must be taken into account, even if the NHCE is not eligible for a matching contribution. This means that a plan with a provision which limits matching contributions to employees who are employed on the last day of the plan year will not be able to satisfy the ACP safe harbor, since a NHCE who is not eligible to receive a matching contribution on account of the last day requirement will nonetheless be taken into consideration in determining whether the plan satisfies section 401(m)(11)(B)(iii). The proposed regulations also include the requirement that matching contributions made at the employer's discretion with respect to any employee cannot exceed a dollar amount equal to 4% of the employee's compensation and that a safe harbor plan must permit all eligible NHCEs to make sufficient elective contributions (or employee contributions, if applicable) to receive the maximum matching contribution provided under the plan.

The proposed regulations would provide a special rule for satisfying section 401(m)(11)(B)(iii) in the case of an HCE who participates in two or more plans that provide for matching contributions. Under this rule, a plan will not fail to satisfy the requirements of section 401(m)(11)(B)(iii) merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that the HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and the period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan. In such a case, an HCE can transfer from a plan with a more generous matching schedule to an otherwise safe harbor section 401(m) plan (for example, as a result of switching jobs within the controlled group) without causing the safe harbor plan to violate section 401(m)(11). However, the plan which is not the safe harbor plan will still have to aggregate matching contributions for the HCE under the rule set forth in section 401(m)(2)(B).

The safe harbor in section 401(m)(11) does not apply to employee contributions. Consequently, a plan that provides for employee contributions and matching contributions must satisfy the ACP test even though the matching contributions satisfy the safe harbor requirements for section 401(m)(11). However, the proposed regulations would also adopt the position in Notice 98–52 that the ACP test is permitted to be applied by disregarding all matching contributions with respect to all eligible employees. If the ADP safe harbor using matching contributions is satisfied but the ACP safe harbor is not satisfied, the proposed regulations would adopt the position in Notice 98–52 that the ACP test is permitted to be applied disregarding matching contributions for any employee that do not exceed 4% of compensation.

Proposed Effective Date

The regulations are proposed to apply for plan years beginning no sooner than 12 months after publication of final regulations in the **Federal Register**. However, it is anticipated that the preamble for the final regulations will permit plan sponsors to implement the final regulations for the first plan year beginning after publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the conclusion that few plans containing qualified CODAs will correct excess contributions through the recharacterization of these amounts as employee contributions under §1.401(k)–2(b)(3) of these proposed regulations. The collections of information contained in §§1.401(k)–3(d), (f) and 1.401(m)–3(e) are required by statutory provisions. However, the IRS has considered alternatives that would lessen the impact of these statutory requirements on small entities and has requested comments on the use of electronic media to satisfy these notice requirements. Thus, the collection of information in these regulations will not have a significant economic impact on a substantial number of small entities. Therefore, an analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. In addition to the other requests for comments set forth in this document, the IRS and Treasury also request comments on the clarity of the proposed rule and how it may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 12, 2003, at 10 a.m. in the IRS Auditorium (7th Floor), Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue, NW, entrance, located between 10^{th} and 12^{th} Streets, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 22, 2003.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are R. Lisa Mojiri-Azad and John T. Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

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Proposed Amendments to The Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805

26 U.S.C. 401(m)(9) * * *

Par. 2. Sections 1.401(k)–0 and 1.401(k)–1 are revised and §§1.401(k)–2 through 1.401(k)–6 are added to read as follows:

§1.401(k)–0 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(k)–1 through 1.401(k)–6.

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LIST OF PARAGRAPHS

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§1.401(k)–5 Special rules for mergers, acquisitions and similar events. [Reserved]

§1.401(k)–6 Definitions.

§1.401(k)–1 Certain cash or deferred arrangements.

(a) *General rules*—(1) *Certain plans permitted to include cash or deferred arrangements*. A plan, other than a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, does not satisfy the requirements of section 401(a) if the plan includes a cash or deferred arrangement. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a cash or deferred arrangement. A cash or deferred arrangement is part of a plan for purposes of this section if any contributions to the plan, or accruals or other benefits under the plan, are made or provided pursuant to the cash or deferred arrangement.

(2) *Rules applicable to cash or deferred arrangements generally*—(i) *Definition of cash or deferred arrangement*. Except as provided in paragraphs (a)(2)(ii) and (iii) of this section, a cash or deferred arrangement is an arrangement under which an eligible employee may make a cash or deferred election with respect to contributions to, or accruals or other benefits under, a plan that is intended to satisfy the requirements of section 401(a) (including a contract that is intended to satisfy the requirements of section 403(a)).

(ii) *Treatment of after-tax employee contributions*. A cash or deferred arrangement does not include an arrangement under which amounts contributed under a plan at an employee's election are designated or treated at the time of contribution as after-tax employee contributions (*e.g.*, by treating the contributions as taxable income subject to applicable withholding requirements). See also section 414(h)(1). This is the case even if the employee's election to make after-tax employee contributions is made before the amounts subject to the election are currently available to the employee.

(iii) *Treatment of ESOP dividend election*. A cash or deferred arrangement does not include an arrangement under an ESOP under which dividends are either distributed or invested pursuant to an election made by participants or their beneficiaries in accordance with section 404(k)(2)(A)(iii).

(iv) *Treatment of elective contributions as plan assets.* The extent to which elective contributions constitute plan assets for purposes of the prohibited transaction provisions of section 4975 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. See 29 CFR 2510.3–102.

(3) *Rules applicable to cash or deferred elections generally*—(i) *Definition of cash or deferred election.* A cash or deferred election is any direct or indirect election (or modification of an earlier election) by an employee to have the employer either—

(A) Provide an amount to the employee in the form of cash (or some other taxable benefit) that is not currently available; or

(B) Contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation.

(ii) *Automatic enrollment.* For purposes of determining whether an election is a cash or deferred election, it is irrelevant whether the default that applies in the absence of an affirmative election is described in paragraph (a)(3)(i)(A) of this section (*i.e.*, the employee receives an amount in cash or some other taxable benefit) or in paragraph (a)(3)(i)(B) of this section (*i.e.*, the employer contributes an amount to a trust or provides an accrual or other benefit under a plan deferring the receipt of compensation).

(iii) *Rules related to timing*—(A) *Requirement that amounts not be currently available.* A cash or deferred election can only be made with respect to an amount that is not currently available to the employee on the date of the election. Further, a cash or deferred election can only be made with respect to amounts that would (but for the cash or deferred election) become currently available after the later of the date on which the employer adopts the cash or deferred arrangement or the date on which the arrangement first becomes effective.

(B) *Contribution may not precede election.* A contribution is made pursuant to a cash or deferred election only if the contribution is made after the election is made. In addition, a contribution is made pursuant to a cash or deferred election only if the contribution is made after the employee's performance of services with respect to which the contribution is made (or when the cash or other taxable benefit would be currently available, if earlier).

(iv) *Current availability defined.* Cash or another taxable benefit is currently available to the employee if it has been paid to the employee or if the employee is able currently to receive the cash or other taxable benefit at the employee's discretion. An amount is not currently available to an employee if there is a significant limitation or restriction on the employee's right to receive the amount currently. Similarly, an amount is not currently available as of a date if the employee may under no circumstances receive the amount before a particular time in the future. The determination of whether an amount is currently available to an employee does not depend on whether it has been constructively received by the employee for purposes of section 451.

(v) *Certain one-time elections not treated as cash or deferred elections.* A cash or deferred election does not include a one-time irrevocable election upon an employee's commencement of employment with the employer, or upon the employee's first becoming eligible under the plan or any other plan of the employer (whether or not such other plan has terminated), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans of the employer (including plans not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Thus, for example, employer contributions made pursuant to a one-time irrevocable election described in this paragraph are not treated as having been made pursuant to a cash or deferred election and are not includible in an employee's gross income by reason of §1.402(a)–1(d). In the case of an irrevocable election made on or before December 23, 1994—

(A) The election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because an employee was previously eligible under another plan of the employer (whether or not such other plan has terminated); and

(B) In the case of a plan in which partners may participate, the election does not fail to be treated as a one-time irrevocable election under this paragraph (a)(3)(v) merely because the election was made after commencement of employment or after the employee's first becoming eligible under any plan of the employer, provided that the election was made before the first day of the first plan year beginning after December 31,1988, or, if later, March 31,1989.

(vi) *Tax treatment of employees.* An amount generally is includible in an employee's gross income for the taxable year in which the employee actually or constructively receives the amount. But for sections 402(e)(3) and 401(k), an employee is treated as having received an amount that is contributed to a plan pursuant to the employee's cash or deferred election. This is the case even if the election to defer is made before the year in which the amount is earned, or before the amount is currently available. See §1.402(a)–1(d).

(vii) *Examples.* The following examples illustrate the application of paragraph (a)(3) of this section:

Example 1. (i) An employer maintains a profit-sharing plan under which each eligible employee has an election to defer an annual bonus payable on January 30 each year. The bonus equals 10% of compensation during the previous calendar year. Deferred amounts are not treated as after-tax employee contributions. The bonus is currently available on January 30.

(ii) An election made prior to January 30 to defer all or part of the bonus is a cash or deferred election, and the bonus deferral arrangement is a cash or deferred arrangement.

Example 2. (i) An employer maintains a profit-sharing plan which provides for discretionary profit sharing contributions and under which each eligible employee may elect to reduce his compensation by up to 10% and to have the employer contribute such amount to the plan. The employer pays each employee every two weeks for services during the immediately preceding two weeks. The employee's election to defer compensation for a payroll period must be made prior to the date the amount would otherwise be paid. The employer contributes to the plan the amount of compensation that each employee elected to defer, at the time it would otherwise be paid to the employee, and does not treat the contribution as an after-tax employee contribution.

(ii) The election is a cash or deferred election and the contributions are elective contributions.

Example 3. (i) The facts are the same as in *Example 2*, except that the employer makes a $10,000 contribution on January 31 of the plan year that is in addition to the contributions that satisfy the employer's obligation to make contributions with respect to cash or deferred elections for prior payroll periods. Employee A makes an election on February 15 to defer $2,000 from compensation that is not currently available and the employer reduces the employee's compensation to reflect the election.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election, because the contribution was made before the election was made. Accordingly, the employer must make an additional contribution of $2,000 in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution can be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 4. (i) The facts are the same as in *Example 3*, except that Employee A had an outstanding election to defer $500 from each payroll period's compensation.

(ii) None of the additional $10,000 contributed January 31 is a contribution made pursuant to Employee A's cash or deferred election for future payroll periods, because the contribution was made before the earlier of Employee A's performance of services to which the contribution is attributable or when the compensation would be currently available. Accordingly, the employer must make an additional contribution of $500 per payroll period in order to satisfy its obligation to contribute an amount to the plan pursuant to Employee A's election. The $10,000 contribution can be allocated under the plan terms providing for discretionary profit sharing contributions.

Example 5. (i) Employer B establishes a money purchase pension plan in 1986. This is the first qualified plan established by Employer B. All salaried employees are eligible to participate under the plan. Hourly-paid employees are not eligible to participate under the plan. In 2000, Employer B establishes a profit-sharing plan under which all employees (both salaried and hourly) are eligible. Employer B permits all employees on the effective date of the profit-sharing plan to make a one-time irrevocable election to have Employer B contribute 5% of compensation on their behalf to the plan and make no other contribution to any other plan of Employer B (including plans not yet established) for the duration of the employee's employment with Employer B, and have their salaries reduced by 5%.

(ii) The election provided under the profit-sharing plan is not a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the salaried employees of Employer B who, before becoming eligible to participate under the profit-sharing plan, became eligible to participate under the money purchase pension plan. The election under the profit-sharing plan is a one-time irrevocable election within the meaning of paragraph (a)(3)(v) of this section with respect to the hourly employees, because they were not previously eligible to participate under another plan of the employer.

(4) *Rules applicable to qualified cash or deferred arrangements*—(i) *Definition of qualified cash or deferred arrangement*. A qualified cash or deferred arrangement is a cash or deferred arrangement that satisfies the requirements of paragraphs (b), (c), (d), and (e) of this section.

(ii) *Treatment of elective contributions as employer contributions*. Except as otherwise provided in §1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement are treated as employer contributions. Thus, for example, elective contributions are treated as employer contributions for purposes of sections 401(a) and 401(k), 402, 404, 409, 411, 412, 415, 416, and 417.

(iii) *Tax treatment of employees*. Except as provided in section 402(g), 402A (effective for years beginning after December 31, 2005), or 1.401(k)–2(b)(3), elective contributions under a qualified cash or deferred arrangement are neither includible in an employee's gross income at the time the cash would have been includible in the employee's gross income (but for the cash or deferred election), nor at the time the elective contributions are contributed to the plan. See §1.402(a)–1(d)(2)(i).

(iv) *Application of nondiscrimination requirements to plan that includes a qualified cash or deferred arrangement*—(A) *Exclusive means of amounts testing*. Elective contributions under a qualified cash or deferred arrangement satisfy the requirements of section 401(a)(4) with respect to amounts if and only if the amount of elective contributions satisfies the nondiscrimination test of section 401(k) under paragraph (b)(1) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B).

(B) *Testing benefits, rights and features*. A plan that includes a qualified cash or deferred arrangement must satisfy the requirements of section 401(a)(4) with respect to benefits, rights and features in addition to the requirements regarding amounts described in paragraph (a)(4)(iv)(A) of this section. For example, the right to make each level of elective contributions under a cash or deferred arrangement is a benefit, right or feature subject to the requirements of section 401(a)(4). See §1.401(a)(4)–4(e)(3)(i) and (iii)(D). Thus, for example, if all employees are eligible to make a stated level of elective contributions under a cash or deferred arrangement, but that level of contributions can only be made from compensation in excess of a stated amount, such as the Social Security taxable wage base, the arrangement will generally favor HCEs with respect to the availability of elective contributions and thus will generally not satisfy the requirements of section 401(a)(4).

(C) *Minimum coverage requirement*. A qualified cash or deferred arrangement is treated as a separate plan that must satisfy the requirements of section 410(b). See §1.410(b)–7(c)(1) for special rules. The determination of whether a cash or deferred arrangement satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. See also §1.401(a)(4)–11(g)(3)(vii)(A), relating to corrective amendments that may be made to satisfy the minimum coverage requirements of section 410(b).

(5) *Rules applicable to nonqualified cash or deferred arrangements*—(i) *Definition of nonqualified cash or deferred arrangement*. A nonqualified cash or deferred arrangement is a cash or deferred arrangement that fails to satisfy one or more of the requirements in paragraph (b), (c), (d) or (e) of this section.

(ii) *Treatment of elective contributions as nonelective contributions*. Except as specifically provided otherwise, elective contributions under a nonqualified cash or deferred arrangement are treated as nonelective employer contributions. Thus, for example, the elective contributions are treated as nonelective employer contributions for purposes of sections 401(a) (including section 401(a)(4)) and 401(k), 404, 409, 411, 412, 415, 416, and 417 and are not subject to the requirements of section 401(m).

(iii) *Tax treatment of employees*. Elective contributions under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the cash or other taxable amount that the employee would have received (but for the cash or deferred election) would have been includible in the employee's gross income. See §1.402(a)–1(d)(1).

(iv) *Qualification of plan that includes a nonqualified cash or deferred arrangement*—(A) *In general*. A profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan does not fail to satisfy the requirements of section 401(a) merely because the plan includes a nonqualified cash or deferred arrangement. In determining whether the plan satisfies the requirements of section 401(a)(4), the nondiscrimination tests of sections 401(k), paragraph (b)(1) of this section, section 401(m)(2) and §1.401(m)–1(b) may not be used. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–9 (definition of section 401(k) plan).

(B) *Application of section 401(a)(4) to certain plans*. The amount of employer contributions under a nonqualified cash or deferred arrangement is treated as satisfying section 401(a)(4) if the arrangement is part of a collectively bargained plan that automatically satisfies the requirements of section 410(b). See §§1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a state or local government or political subdivision thereof (or agency or instrumentality thereof). See sections 401(a)(5) and 410(c)(1)(A).

(v) *Example*. The following example illustrates the application of this paragraph (a)(5):

Example. (i) For the 2006 plan year, Employer A maintains a collectively bargained plan that includes a cash or deferred arrangement. Employer contributions under the cash or deferred arrangement do not satisfy the nondiscrimination test of section 401(k) and paragraph (b) of this section.

(ii) The arrangement is a nonqualified cash or deferred arrangement. The employer contributions under the cash or deferred arrangement are considered to be nondiscriminatory under section 401(a)(4), and the elective contributions are generally treated as employer contributions under paragraph (a)(5)(ii) of this section. Under paragraph (a)(5)(iii) of this section and under §1.402(a)–1(d)(1), however, the elective contributions are includible in each employee's gross income.

(6) *Rules applicable to cash or deferred arrangements of self-employed individuals*—(i) *Application of general rules*. Generally, a partnership or sole proprietorship is permitted to maintain a cash or deferred arrangement, and individual partners or owners are permitted to make cash or deferred elections with respect to compensation attributable to services rendered to the entity, under the same rules that apply to other cash or deferred arrangements. For example, any contributions made on behalf of an individual partner or owner pursuant to a cash or deferred arrangement of a partnership or sole proprietorship are elective contributions unless they are designated or treated as after-tax employee contributions. In the case of a partnership, a cash or deferred arrangement includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf. Consistent with §1.402(a)–1(d), the elective contributions under such an arrangement are includible in income and are not deductible under section 404(a) unless the arrangement is a qualified cash or deferred arrangement (*i.e.*, the requirements of section 401(k) and this section are satisfied). Also, even if the arrangement is a qualified cash or deferred arrangement, the elective contributions are includible in gross income and are not deductible under section 404(a) to the extent they exceed the applicable limit under section 402(g). See also §1.401(a)–30.

(ii) *Treatment of matching contributions made on behalf of self-employed individuals*. Under section 402(g)(8), matching contributions made on behalf of a self-employed individual are not treated as elective contributions made pursuant to a cash or deferred election, without regard to whether such matching contributions indirectly permit individual partners to vary the amount of contributions made on their behalf.

(iii) *Timing of self-employed individual's cash or deferred election*. For purposes of paragraph (a)(3)(iv) of this section, a partner's compensation is deemed currently available on the last day of the partnership taxable year and a sole proprietor's compensation is deemed currently available on the last day of the individual's taxable year. Accordingly, a self-employed individual may not make a cash or deferred election with respect to compensation for a partnership or sole proprietorship taxable year after the last day of that year. See §1.401(k)–2(a)(4)(ii) for the rules regarding when these contributions are treated as allocated.

(b) *Coverage and nondiscrimination requirements*—(1) *In general*. A cash or deferred arrangement satisfies this paragraph (b) for a plan year only if—

(i) The group of eligible employees under the cash or deferred arrangement (including any employee taken into account for purposes of section 410(b) pursuant to §1.401(a)(4)–11(g)(3)(vii)(A)) satisfies the requirements of section 410(b) (including the average benefit percentage test, if applicable); and

(ii) The cash or deferred arrangement satisfies—

(A) The ADP test of section 401(k)(3) described in §1.401(k)–2;

(B) The ADP safe harbor provisions of section 401(k)(12) described in §1.401(k)–3; or

(C) The SIMPLE 401(k) provisions of section 401(k)(11) described in §1.401(k)–4.

(2) *Automatic satisfaction by certain plans*. Notwithstanding paragraph (b)(1) of this section, a governmental plan (within the meaning of section 414(d)) maintained by a state or local government or political subdivision thereof (or agency or instrumentality thereof) shall be treated as meeting the requirements of this paragraph (b).

(3) *Anti-abuse provisions*. Sections 1.401(k)–1 through 1.401(k)–6 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring*—(i) *In general*. This paragraph (b)(4) contains

the exclusive rules for aggregating and disaggregating plans and cash or deferred arrangements for purposes of this section, and §§1.401(k)–2 through 1.401(k)–6.

(ii) *Aggregation of cash or deferred arrangements within a plan*. Except as otherwise specifically provided in this paragraph (b)(4), all cash or deferred arrangements included in a plan are treated as a single cash or deferred arrangement and a plan must apply a single test under paragraph (b)(1)(ii) of this section with respect to all such arrangements within the plan. Thus, for example, if two groups of employees are eligible for separate cash or deferred arrangements under the same plan, all contributions under both cash or deferred arrangements must be treated as made under a single cash or deferred arrangement subject to a single test, even if they have significantly different features, such as different limits on elective contributions.

(iii) *Aggregation of plans*—(A) *In general*. For purposes of this section and §§1.401(k)–2 through 1.401(k)–6, the term plan means a plan within the meaning of §1.410(b)–7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c), and the permissive aggregation rules of §1.410(b)–7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)–7(d) are treated as a single plan for purposes of section 401(k) and section 401(m).

(B) *Plans with inconsistent ADP testing methods*. Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all cash or deferred arrangements under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)–7(d), an employer may not aggregate plans (within the meaning of §1.410(b)–7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)–7(b)) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)–7(b)) using the ADP safe harbor provisions of section 401(k)(12) and another plan that is using the ADP test of section 401(k)(3).

(iv) *Disaggregation of plans and separate testing*—(A) *In general*. If a cash or deferred arrangement is included in a plan (within the meaning of §1.410(b)–7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the cash or deferred arrangement must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a cash or deferred arrangement are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(k), unless the employer is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan. Similarly, if a cash or deferred arrangement under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the arrangement must be treated as two separate arrangements, one comprising all eligible employees who have met the age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the age and service requirements under section 410(a)(1), unless the plan is using the rule in §1.401(k)–2(a)(1)(iii)(A).

(B) *Restructuring prohibited*. Restructuring under §1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(k). See §1.401(a)(4)–9(c)(3)(ii).

(v) *Modifications to section 410(b) rules*—(A) *Certain disaggregation rules not applicable*. The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)–7(c)(1) and ESOP and non-ESOP portions of a plan set forth in §1.410(b)–7(c)(2) shall not apply for purposes of this section and §§1.401(k)–2 through 1.401(k)–6. Accordingly, notwithstanding §1.410(b)–7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of §1.410(b)–7(b)) are permitted to be aggregated for these purposes.

(B) *Permissive aggregation of collective bargaining units*. Notwithstanding the general rule under section 410(b) and §1.410(b)–7(c) that a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and employees who are not included in the collective bargaining unit is treated as comprising separate plans, an employer can treat two or more separate collective bargaining units as a single collective bargaining unit for purposes of this section and §1.401(k)–2 through §1.401(k)–6, provided that the combinations of units are determined on a basis that is reasonable and reasonably consistent from year to year. Thus, for example, if a plan benefits employees in three categories (*e.g.*, employees included in collective bargaining unit A, employees included in collective bargaining unit B, and employees who are not included in any collective bargaining unit), the plan can be treated as comprising three separate plans, each of which benefits only one category of employees. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as comprising only two separate plans, one benefitting all employees who are included in a collective bargaining unit and another benefitting all other employees. Similarly, if a plan benefits only employees who are included in collective bargaining unit A and employees who are included in collective bargaining unit B, the plan can be treated as comprising two separate plans. However, if collective bargaining units A and B are treated as a single collective bargaining unit, the plan will be treated as a single plan. An employee is treated as included in a unit of employees covered by a collective bargaining agreement if and only if the employee is a collectively bargained employee within the meaning of §1.410(b)–6(d)(2).

(C) *Multiemployer plans*. Notwithstanding §1.410(b)–7(c)(4)(ii)(C), the portion of the plan that is maintained pursuant to a collective bargaining agreement (within the meaning of §1.413–1(a)(2)) is treated as a single plan maintained by a single employer that employs all the employees benefitting under the same benefit computation formula and covered pursuant to that collective bargaining agreement. The rules of paragraph (b)(4)(v)(B) of this section (including the permissive aggregation of collective bargaining units) apply to the resulting deemed single plan in the same manner as they would to a single employer plan, except that the plan administrator is substituted for the employer where appropriate and appropriate fiduciary obligations are taken into account. The noncollectively bargained portion of the plan is treated as maintained by one or more employers, depending on whether the noncollectively bargaining unit employees who benefit under the plan are employed by one or more employers.

(vi) *Examples*. The following examples illustrate the application of this paragraph (b)(4):

Example 1. (i) Employer A maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer A are eligible to participate. For purposes of applying section 410(b), Employer A is treated as operating qualified separate lines of business under section 414(r) in accordance with §1.414(r)–1(b). However, Employer A applies the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) to the portion of its profit-sharing plan that consists of elective contributions under the cash or deferred arrangement (and to no other plans or portions of plans).

(ii) Under these facts, the requirements of this section and §§1.401(k)–2 through 1.401(k)–6 must be applied on an employer-wide rather than a qualified separate line of business basis.

Example 2. (i) Employer B maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement in which all of the employees of Employer B are eligible to participate. For purposes of applying section 410(b), the plan treats the cash or deferred arrangement as two separate plans, one for the employees who have completed the minimum age and service eligibility conditions under section 410(a)(1) and the other for employees who have not completed the conditions. The plan provides that it will satisfy the section 401(k) safe harbor requirement of §1.401(k)–3 with respect to the employees who have met the minimum age and service conditions and that it will meet the ADP test requirements of §1.401(k)–2 with respect to the employees who have not met the minimum age and service conditions.

(ii) Under these facts, the cash or deferred arrangement must be disaggregated on a consistent basis with the disaggregation of Plan W. Thus, the requirements of §1.401(k)–2 must be applied by comparing the ADP for eligible HCEs who have not completed the minimum age and service conditions with the ADP for eligible NHCEs for the applicable year who have not completed the minimum age and service conditions.

Example 3. (i) Employer C maintains Plan X, a stock-bonus plan including an ESOP. The plan also includes a cash or deferred arrangement for participants in the ESOP and non-ESOP portions of the plan.

(ii) Pursuant to paragraph (b)(4)(v)(A) of this section the ESOP and non-ESOP portions of the stock-bonus plan are a single cash or deferred arrangement for purposes of this section and §§1.401(k)–2 through 1.401(k)–6. However, as provided in paragraph (a)(4)(iv)(C) of this section, the ESOP and non-ESOP portions of the plan are still treated as separate plans for purposes of satisfying the requirements of section 410(b).

(c) *Nonforfeitability requirements*—(1) *General rule*. A cash or deferred arrangement satisfies this paragraph (c) only if the amount attributable to an employee's elective contributions are immediately nonforfeitable, within the meaning of paragraph (c)(2) of this section, are disregarded for purposes of applying section 411(a) to other contributions or benefits, and the contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

(2) *Definition of immediately nonforfeitable*. An amount is immediately nonforfeitable if it is immediately nonforfeitable within the meaning of section 411, and would be nonforfeitable under the plan regardless of the age and service of the employee or whether the employee is employed on a specific date. An amount that is subject to forfeitures or suspensions permitted by section 411(a)(3) does not satisfy the requirements of this paragraph (c).

(3) *Example*. The following example illustrates the application of this paragraph (c):

Example. (i) Employees B and C are covered by Employer Y's stock bonus plan, which includes a cash or deferred arrangement. All employees participating in the plan have a nonforfeitable right to a percentage of their account balance derived from all contributions (including elective contributions) as shown in the following table:

Years of service	Nonforfeitable percentage
Less than 1	0%
1	20%
2	40%
3	60%
4	80%
5 or more	100%

(ii) The cash or deferred arrangement does not satisfy paragraph (c) of this section because elective contributions are not immediately nonforfeitable. Thus, the cash or deferred arrangement is a nonqualified cash or deferred arrangement.

(d) *Distribution limitation*—(1) *General rule*. A cash or deferred arrangement satisfies this paragraph (d) only if amounts attributable to elective contributions may not be distributed before one of the following events, and any distributions so permitted also satisfy the additional requirements of paragraphs (d)(2) through (5) of this section (to the extent applicable)—

(i) The employee's death, disability, or severance from employment;

(ii) In the case of a profit-sharing, stock bonus or rural cooperative plan, the employee's attainment of age 59½, or the employee's hardship; or

(iii) The termination of the plan.

(2) *Rules applicable to distributions upon severance from employment*. An employee has a severance from employment when the employee ceases to be an employee of the employer maintaining the plan. An employee does not have a severance from employment if, in connection with a change of employment, the employee's new employer maintains such plan with respect to the employee. For example, a new employer maintains a plan with respect to an employee by continuing or assuming sponsorship of the plan or by accepting a transfer of plan assets and liabilities (within the meaning of section 414(l)) with respect to the employee).

(3) *Rules applicable to hardship distributions*—(i) *Distribution must be on account of hardship*. A distribution is treated as made after an employee's hardship for purposes of paragraph (d)(1)(ii) of this section if and only if it is made on account of the hardship. For purposes of this rule, a distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and 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.

(ii) *Limit on maximum distributable amount*—(A) *General rule*. A distribution on account of hardship must be limited to the maximum distributable amount. The maximum distributable amount is equal to the employee's total elective contributions as of the date of distribution, reduced by the amount of previous distributions of elective contributions. Thus, the maximum distributable amount does not include earnings, QNECs or QMACs, unless grandfathered under paragraph (d)(3)(ii)(B) of this section.

(B) *Grandfathered amounts*. If the plan provides, the maximum distributable amount may be increased for amounts credited to the employee's account as of a date specified in the plan that is no later than December 31, 1988, or if later, the end of the last plan year ending before July 1, 1989 (or in the case of a collectively bargained plan, the earlier of—

(*1*) the later of January 1, 1989, or the date on which the last of the collective bargaining agreements in effect on March 1, 1986, terminates (determined without regard to any extension thereof after February 28, 1986); or

(*2*) January 1, 1991, and consisting of—

(*i*) Income allocable to elective contributions;

(*ii*) Qualified nonelective contributions and allocable income; and

(*iii*) Qualified matching contributions and allocable income.

(iii) *Immediate and heavy financial need*—(A) *In general*. Whether an employee has an immediate and heavy financial need is to be determined based on all the relevant facts and circumstances. Generally, for example, the need to pay the funeral expenses of a family member would constitute an immediate and heavy financial need. A distribution made to an employee for the purchase of a boat or television would generally not constitute a distribution made on account of an immediate and heavy financial need. A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred by the employee.

(B) *Deemed immediate and heavy financial need*. A distribution is deemed to be on account of an immediate and heavy financial need of the employee if the distribution is for—

(*1*) Expenses for medical care described in section 213(d) previously incurred by the employee, the employee's spouse, or any dependents of the employee (as defined in section 152) or necessary for these persons to obtain medical care described in section 213(d);

(*2*) Costs directly related to the purchase of a principal residence for the employee (excluding mortgage payments);

(*3*) Payment of tuition, related educational fees, and room and board expenses, for up to the next 12 months of post-secondary education for the employee, or the employee's spouse, children, or dependents (as defined in section 152); or

(*4*) Payments necessary to prevent the eviction of the employee from the employee's principal residence or foreclosure on the mortgage on that residence.

(iv) *Distribution necessary to satisfy financial need*—(A) *Distribution may not exceed amount of need*. A distribution is treated as necessary to satisfy an immediate and heavy financial need of an employee only to the extent the amount of the distribution is not in excess of the amount required to satisfy the financial need. For this purpose, the amount required to satisfy the financial need may include any amounts necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

(B) *No alternative means available*. A distribution is not treated as necessary to satisfy an immediate and heavy financial need of an employee to the extent the need may be relieved from other resources that are reasonably available to the employee. This determination generally is to be made on the basis of all the relevant facts and circumstances. For purposes of this paragraph (d)(3)(iv), the employee's resources are deemed to include those assets of the employee's spouse and minor children that are reasonably available to the employee. Thus, for example, a vacation home owned by the employee and the employee's spouse, whether as community property, joint tenants, tenants by the entirety, or tenants in common, generally will be deemed a resource of the employee. However, property held for the employee's child under an irrevocable trust or under the Uniform Gifts to Minors Act (or comparable State law) is not treated as a resource of the employee.

(C) *Employer reliance on employee representation*. For purposes of paragraph (d)(3)(iv)(B) of this section, an immediate and heavy financial need generally may be treated as not capable of being relieved from other resources that are reasonably available to the employee, if the employer relies upon the employee's written representation, unless the employer has actual knowledge to the contrary, that the need cannot reasonably be relieved—

(*1*) Through reimbursement or compensation by insurance or otherwise;

(*2*) By liquidation of the employee's assets;

(*3*) By cessation of elective contributions or employee contributions under the plan;

(*4*) By other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or

(*5*) By borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(D) *Employee need not take counterproductive actions*. For purposes of this paragraph (d)(3)(iv), a need cannot reasonably be relieved by one of the actions described in paragraph (d)(3)(iv)(C) of this section if the effect would be to increase the amount of the need. For example, the need for funds to purchase a principal residence cannot reasonably be relieved by a plan loan if the loan would disqualify the employee from obtaining other necessary financing.

(E) *Distribution deemed necessary to satisfy immediate and heavy financial need*. A distribution is deemed necessary to satisfy an immediate and heavy financial need of an employee if each of the following requirements are satisfied—

(*1*) The employee has obtained all distributions, other than hardship distributions, and all nontaxable (at the time of the loan) loans currently available under the plan and all other plans maintained by the employer; and

(*2*) The employee is prohibited, under the terms of the plan or an otherwise legally enforceable agreement, from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 6 months after receipt of the hardship distribution.

(F) *Definition of other plans*. For purposes of paragraph (d)(3)(iv)(C)(*4*) and (E)(*1*) of this section, the phrase "plans maintained by the employer" means all qualified and nonqualified plans of deferred compensation maintained by the employer, including a cash or deferred arrangement that is part of a cafeteria plan within the meaning of section 125. However, it does not include the mandatory employee contribution portion of a defined benefit plan or a health or welfare benefit plan (including one that is part of a cafeteria plan). In addition, for purposes of paragraph (d)(3)(iv)(E)(*2*) of this section, the phrase "plans maintained by the employer" also includes a stock option, stock purchase, or similar plan maintained by the employer. See §1.401(k)–6 for the continued treatment of suspended employees as eligible employees.

(v) *Commissioner may expand standards*. The Commissioner may prescribe additional guidance of general applicability, published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter), expanding the list of deemed immediate and heavy financial needs and prescribing additional methods for distributions to be deemed necessary to satisfy an immediate and heavy financial need.

(4) *Rules applicable to distributions upon plan termination*—(i) *No alternative defined contribution plan*. A distribution may not be made under paragraph (d)(1)(iii) of this section if the employer establishes or maintains an alternative defined contribution plan. For purposes of the preceding sentence, the definition of the term "employer" contained in §1.401(k)–6 is applied as of the date of plan termination, and a plan is an alternative defined contribution plan only if it is a defined contribution plan that exists at any time during the period beginning on the date of plan termination and ending 12 months after distribution of all assets from the terminated plan. However, if at all times during the 24-month period beginning 12 months before the termination, fewer than 2% of the employees who were eligible under the defined contribution plan that includes the cash or deferred arrangement as of the date of plan termination are eligible under the other defined contribution plan, the other plan is not an alternative defined contribution plan. In addition, a defined contribution plan is not treated as an alternative defined contribution plan if it is an employee stock ownership plan as defined in section 4975(e)(7) or 409(a), a simplified employee pension as defined in section 408(k), a SIMPLE IRA plan as defined in section 408(p), a plan or contract that satisfies the requirements of section 403(b), or a plan that satisfies the requirements of section 457.

(ii) *Lump sum requirement for certain distributions*. A distribution may be made under paragraph (d)(1)(iii) of this section only if it is a lump sum distribution. The term lump sum distribution has the meaning provided in section 402(e)(4)(D) (without regard to section 402(e)(4)(D)(i)(I), (II), (III) and (IV)). In addition, a lump sum distribution includes a distribution of an annuity contract from a trust that is part of a plan described in section 401(a) and which is exempt from tax under section 501(a) or an annuity plan described in 403(a).

(5) *Rules applicable to all distributions*—(i) *Exclusive distribution rules*. Amounts attributable to elective contributions may not be distributed on account of any event not described in this paragraph (d), such as completion of a stated period of plan participation or the lapse of a fixed number of years. For example, if excess deferrals (and income) for an employee's taxable year are not distributed within the time prescribed in §1.402(g)–1(e)(2) or (3), the amounts may be distributed only on account of an event described in this paragraph (d). Pursuant to section 401(k)(8), the prohibition on distributions set forth in this section does not apply to a distribution of excess contributions under §1.401(k)–2(b). In addition, the prohibition on distributions set forth in this paragraph (d) does not apply to a distribution of excess annual additions pursuant to §1.415–6(b)(6)(iv).

(ii) *Deemed distributions*. The cost of life insurance (determined under section 72) is not treated as a distribution for purposes of section 401(k)(2) and this paragraph (d). The making of a loan is not treated as a distribution, even if the loan is secured by the employee's accrued benefit attributable to elective contributions or is includible in the employee's income under section 72(p). However, the reduction, by reason of default on a loan, of an employee's accrued benefit derived from elective contributions is treated as a distribution.

(iii) *ESOP dividend distributions*. A plan does not fail to satisfy the requirements of this paragraph (d) merely by reason of a dividend distribution described in section 404(k)(2).

(iv) *Limitations apply after transfer*. The limitations of this paragraph (d) generally continue to apply to amounts attributable to elective contributions (including QNECs and qualified matching contributions taken into account for the ADP test under §1.401(k)–2(a)(6)) that are transferred to another qualified plan of the same or another employer. Thus, the transferee plan will generally fail to satisfy the requirements of section 401(a) and this section if transferred amounts may be distributed before the times specified in this paragraph (d). In addition, a cash or deferred arrangement fails to satisfy the limitations of this paragraph (d) if it transfers amounts to a plan that does not provide that the transferred amounts may not be distributed before the times specified in this paragraph (d). The transferor plan does not fail to comply with the preceding sentence if it reasonably concludes that the transferee plan provides that the transferred amounts may not be distributed before the times specified in this paragraph (d). What constitutes a basis for a reasonable conclusion is comparable to the rules related to acceptance of rollover distributions. See §1.401(a)(31)–1, A–14. The limitations of this paragraph (d) cease to apply after the transfer, however, if the amounts could have been distributed at the time of the transfer (other than on account of hardship), and the transfer is an elective transfer described in §1.411(d)–4, Q&A–3(b)(1). The limitations of this paragraph (d) also do not apply to amounts that have been paid in a direct rollover to the plan after being distributed by another plan.

(6) *Examples*. The following examples illustrate the application of this paragraph (d):

Example 1. Employer M maintains Plan V, a profit-sharing plan that includes a cash or deferred arrangement. Elective contributions under the arrangement may be withdrawn for any reason after two years following the end of the plan year in which the contributions were made. Because the plan permits distributions of elective contributions before the occurrence of one of the events specified in section 401(k)(2)(B) and this paragraph (d), the cash or deferred arrangement is a nonqualified cash or deferred arrangement and the elective contributions are currently includible in income under section 402.

Example 2. (i) Employer N maintains Plan W, a profit-sharing plan that includes a cash or deferred arrangement. Plan W provides for distributions upon a participant's severance from employment, death or disability. All employees of Employer N and its wholly owned subsidiary, Employer O, are eligible to participate in Plan W. Employer N agrees to sell all issued and outstanding shares of Employer O to an unrelated entity, Employer T, effective on December 31, 2006. Following the transaction, Employer O will be a wholly owned subsidiary of Employer T. Additionally, individuals who are employed by Employer O on the effective date of the sale continue to be employed by Employer O following the sale. Following the transaction, all employees of Employer O will cease to participate in Plan W and will become eligible to participate in the cash or deferred arrangement maintained by Employer T, Plan X. No assets will be transferred from Plan W to Plan X, except in the case of a direct rollover within the meaning of section 401(a)(31).

(ii) Employer O ceases to be a member of Employer N's controlled group as a result of the sale. Therefore, employees of Employer O who participated in Plan W will have a severance from employment and are eligible to receive a distribution from Plan W.

Example 3. (i) Employer Q maintains Plan Y, a profit-sharing plan that includes a cash or deferred arrangement. Plan Y, the only plan maintained by Employer Q, does not provide for loans. However, Plan Y provides that elective contributions under the arrangement may be distributed to an eligible employee on account of hardship using the deemed immediate and heavy financial need provisions of paragraph (d)(3)(iii)(B) of this section and provisions regarding distributions necessary to satisfy financial need of paragraphs (d)(3)(iv)(A) through (D) of this section. Employee A is an eligible employee in Plan Y with an account balance of $50,000 attributable to elective contributions made by Employee A. The total amount of elective contributions made by Employee A, who has not previously received a distribution from Plan Y, is $20,000. Employee A requests a $15,000 hardship distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent child. At the time of the distribution request, the sole asset of Employee A (that is reasonably available to Employee A within the meaning of paragraph (d)(3)(iv)(B) of this section) is a savings account with an available balance of $10,000.

(ii) A distribution is made on account of hardship only if the distribution both is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need. Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependant child is deemed to be on account of an immediate and heavy financial need of Employee A.

(iii) A distribution is treated as necessary to satisfy Employee A's immediate and heavy financial need to the extent the need may not be relieved from other resources reasonably available to Employee A. Under paragraph (d)(3)(iv)(B) of this section, Employee A's $10,000 savings account is a resource that is reasonably available to the employee and must be taken into account in determining the amount necessary to satisfy Employee A's immediate and heavy financial need. Thus, Employee A may receive a distribution of only $5,000 of his elective contributions on account of this hardship, plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 4. (i) The facts are the same as in *Example 3*. Employee B, another employee of Employer Q has an account balance of $25,000, attributable to Employee B's elective contributions. The total amount of elective contributions made by Employee B, who has not previously received a distribution from Plan Y, is $15,000. Employee B requests a $10,000 distribution of his elective contributions to pay 6 months of college tuition and room and board expenses for his dependent child. Employee B makes a written representation (with respect to which Employer Q has no actual knowledge to the contrary) that the need cannot reasonably be relieved: 1) through reimbursement or compensation by insurance or otherwise; 2) by liquidation of the employee's assets; 3) by cessation of elective contributions or employee contributions under the plan; 4) by other distributions or nontaxable (at the time of the loan) loans from plans maintained by the employer or by any other employer; or 5) by borrowing from commercial sources on reasonable commercial terms in an amount sufficient to satisfy the need.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee B's dependant child is deemed to be on account of an Employee B's immediate and heavy financial need. In addition, because Employer Q can rely on Employee B's written representation, the distribution is considered necessary to satisfy Employee B's immediate and heavy financial need. Therefore, Employee B may receive a $10,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 5. (i) The facts are the same as in *Example 3*, except Plan Y provides for hardship distributions using the safe harbor rule of paragraph (d)(3)(iv)(E) of this section. Accordingly, Plan Y provides for a 6 month suspension of an eligible employee's elective contributions and employee contributions to the plan after the receipt of a hardship distribution by such eligible employee.

(ii) Under paragraph (d)(3)(iii)(B) of this section, a distribution for payment of up to the next 12 months of post-secondary education and room and board expenses for Employee A's dependant child is deemed to be on account of an Employee A's immediate and heavy financial need. In addition, because Employee A is not eligible for any other distribution or loan from Plan Y and Plan Y suspends Employee A's elective contributions and employee contributions following receipt of the hardship distribution, the distribution will be deemed necessary to satisfy Employee A's immediate and heavy financial need (and Employee A is not required to first liquidate his savings account). Therefore, Employee A may receive a $15,000 distribution of his elective contributions on account of hardship plus an amount necessary to pay any federal, state, or local income taxes or penalties reasonably anticipated to result from the distribution.

Example 6. Employer R maintains a pre-ERISA money purchase pension plan that includes a cash or deferred arrangement that is not a rural cooperative plan. Elective contributions under the arrangement may be distributed to an employee on account of hardship. Under paragraph (d)(1) of this section, hardship is a permissible distribution event only in a profit-sharing, stock bonus or rural cooperative plan. Since elective contributions under the arrangement may be distributed before a permissible distribution event occurs, the cash or deferred arrangement does not satisfy this paragraph (d), and is not a qualified cash or deferred arrangement. Moreover, the plan is not a qualified plan because a money purchase pension plan may not provide for payment of benefits upon hardship. See §1.401–1(b)(1)(i).

(e) *Additional requirements for qualified cash or deferred arrangements*—(1) *Qualified plan requirement*. A cash or deferred arrangement satisfies this paragraph (e) only if the plan of which it is a part is a profit-sharing, stock bonus, pre-ERISA money purchase or rural cooperative plan that otherwise satisfies the requirements of section 401(a) (taking into account the cash or deferred arrangement). A plan that includes a cash or deferred arrangement may provide for other contributions, including employer contributions (other than elective contributions), employee contributions, or both. However, except as expressly permitted under section 401(m), 410(b)(2)(A)(ii) or 416(c)(2)(A), elective contributions and matching contributions taken into account under §1.401(k)–2(a) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the contributions are made) satisfy the requirements of section 401(a).

(2) *Election requirements*—(i) *Cash must be available*. A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides that the amount that each eligible employee may defer as an elective contribution is available to the employee in cash. Thus, for example, if an eligible employee is provided the option to receive a taxable benefit (other than cash) or to have the employer contribute on the employee's behalf to a profit-sharing plan an amount equal to the value of the taxable benefit, the arrangement is not a qualified cash or deferred arrangement. Similarly, if an employee has the option to receive a specified amount in cash or to have the employer contribute an amount in excess of the specified cash amount to a profit-sharing plan on the employee's behalf, any contribution made by the employer on the employee's behalf in excess of the specified cash amount is not treated as made pursuant to a qualified cash or deferred arrangement.

This cash availability requirement applies even if the cash or deferred arrangement is part of a cafeteria plan within the meaning of section 125.

(ii) *Frequency of elections*. A cash or deferred arrangement satisfies this paragraph (e) only if the arrangement provides an employee with an effective opportunity to make (or change) a cash or deferred election at least once during each plan year. Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.

(3) *Separate accounting requirement*—(i) *General rule*. A cash or deferred arrangement satisfies this paragraph (e) only if the portion of an employee's benefit subject to the requirements of paragraphs (c) and (d) of this section is determined by an acceptable separate accounting between that portion and any other benefits. Separate accounting is not acceptable unless gains, losses, withdrawals, and other credits or charges are separately allocated on a reasonable and consistent basis to the accounts subject to the requirements of paragraphs (c) and (d) of this section and to other accounts. Subject to section 401(a)(4), forfeitures are not required to be allocated to the accounts in which benefits are subject to paragraphs (c) and (d) of this section.

(ii) *Satisfaction of separate accounting requirement*. The requirements of paragraph (e)(3)(i) of this section are treated as satisfied if all amounts held under a plan that includes a cash or deferred arrangement (and, if applicable, under another plan to which QNECs and QMACs are made) are subject to the requirements of paragraphs (c) and (d) of this section.

(4) *Limitations on cash or deferred arrangements of state and local governments*—(i) *General rule*. A cash or deferred arrangement does not satisfy the requirements of this paragraph (e) if the arrangement is adopted after May 6, 1986, by a state or local government or political subdivision thereof, or any agency or instrumentality thereof (a governmental unit). For purposes of this paragraph (e)(4), an employer that has made a legally binding commitment to adopt a cash or deferred arrangement is treated as having adopted the arrangement on that date.

(ii) *Rural cooperative plans and Indian tribal governments*. This paragraph (e)(4) does not apply to a rural cooperative plan or to a plan of an employer which is an Indian tribal government (as defined in section 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with section 7871(d)), an agency or instrumentality of an Indian tribal government or subdivision thereof, or a corporation chartered under federal, state or tribal law which is owned in whole or in part by any of the entities in this paragraph (e)(4)(ii).

(iii) *Adoption after May 6, 1986*. A cash or deferred arrangement is treated as adopted after May 6, 1986, with respect to all employees of any employer that adopts the arrangement after such date.

(iv) *Adoption before May 7, 1986*. If a governmental unit adopted a cash or deferred arrangement before May 7, 1986, then any cash or deferred arrangement adopted by the unit at any time is treated as adopted before that date. If an employer adopted an arrangement prior to such date, all employees of the employer may participate in the arrangement.

(5) *One-year eligibility requirement*. A cash or deferred arrangement satisfies this paragraph (e) only if no employee is required to complete a period of service with the employer maintaining the plan extending beyond the period permitted under section 410(a)(1) (determined without regard to section 410(a)(1)(B)(i)) to be eligible to make a cash or deferred election under the arrangement.

(6) *Other benefits not contingent upon elective contributions*—(i) *General rule*. A cash or deferred arrangement satisfies this paragraph (e) only if no other benefit is conditioned (directly or indirectly) upon the employee's electing to make or not to make elective contributions under the arrangement. The preceding sentence does not apply to —

(A) Any matching contribution (as defined in §1.401(m)–1(a)(2)) made by reason of such an election;

(B) Any benefit, right or feature (such as a plan loan) that requires, or results in, an amount to be withheld from an employee's pay (*e.g.* to pay for the benefit or to repay the loan), to the extent the cash or deferred arrangement restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes);

(C) Any reduction in the employer's top-heavy contributions under section 416(c)(2) because of matching contributions that resulted from the elective contributions; or

(D) Any benefit that is provided at the employee's election under a plan described in section 125(d) in lieu of an elective contribution under a qualified cash or deferred arrangement.

(ii) *Definition of other benefits*. For purposes of this paragraph (e)(6), other benefits include, but are not limited to, benefits under a defined benefit plan; nonelective contributions under a defined contribution plan; the availability, cost, or amount of health benefits; vacations or vacation pay; life insurance; dental plans; legal services plans; loans (including plan loans); financial planning services; subsidized retirement benefits; stock options; property subject to section 83; and dependent care assistance. Also, increases in salary and bonuses (other than those actually subject to the cash or deferred election) are benefits for purposes of this paragraph (e)(6). The ability to make after-tax employee contributions is a benefit, but that benefit is not contingent upon an employee's electing to make or not make elective contributions under the arrangement merely because the amount of elective contributions reduces dollar-for-dollar the amount of after-tax employee contributions that may be made. Additionally, benefits under any other plan or arrangement (whether or not qualified) are not contingent upon an employee's electing to make or not to make elective contributions under a cash or deferred arrangement merely because the elective contributions are or are not taken into account as compensation under the other plan or arrangement for purposes of determining benefits.

(iii) *Effect of certain statutory limits*. Any benefit under an excess benefit plan described in section 3(36) of the Employee Retirement Income Security Act of 1974 that is dependent on the employee's electing to make or not to make elective contributions is not treated as contingent.

(iv) *Nonqualified deferred compensation*. Participation in a nonqualified deferred compensation plan is treated as contingent for purposes of this paragraph (e)(6) only to the extent that an employee may receive additional deferred compensation under the nonqualified plan to the extent the employee makes or does not make elective contributions. Deferred compensation under a nonqualified plan of deferred compensation that is dependent on an employee's having made the maximum elective deferrals under section 402(g) or the maximum elective contributions permitted under the terms of the plan also is not treated as contingent.

(v) *Plan loans and distributions*. A loan or distribution of elective contributions is not a benefit conditioned on an employee's electing to make or not make elective contributions under the arrangement merely because the amount of the loan or distribution is based on the amount of the employee's account balance.

(vi) *Examples*. The following examples illustrate the application of this paragraph (e)(6):

Example 1. Employer T maintains a cash or deferred arrangement for all of its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the nonqualified deferred compensation plan, R and C are eligible to participate only if they do not make elective contributions under the cash or deferred arrangement. Participation in the nonqualified plan is a contingent benefit for purposes of this paragraph (e)(6), because R's and C's participation is conditioned on their electing not to make elective contributions under the cash or deferred arrangement.

Example 2. Employer T maintains a cash or deferred arrangement for all its employees. Employer T also maintains a nonqualified deferred compensation plan for two highly paid executives, Employees R and C. Under the terms of the arrangements, Employees R and C may defer a maximum of 10% of their compensation, and may allocate their deferral between the cash or deferred arrangement and the nonqualified deferred compensation plan in any way they choose (subject to the overall 10% maximum). Because the maximum deferral available under the nonqualified deferred compensation plan depends on the elective deferrals made under the cash or deferred arrangement, the right to participate in the nonqualified plan is a contingent benefit for purposes of paragraph (e)(6).

(7) *Plan provision requirement*. A plan that includes a cash or deferred arrangement satisfies this paragraph (e) only if it provides that the nondiscrimination requirements of section 401(k) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph (b)(1)(ii) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ADP test of section 401(k)(3), as described in paragraph (b)(1)(ii)(A) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ADP for eligible NHCEs for the first plan year is 3% or the ADP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(k)(12), as described in paragraph (b)(1)(ii)(B) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ADP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (e)(7), a plan may incorporate by reference the provisions of section 401(k)(3) and §1.401(k)–2 if that is the nondiscrimination test being applied.

(f) *Effective dates*—(1) *General rule*. This section and §§1.401(k)–2 through 1.401(k)–6 apply to plan years that begin on or after the date that is 12 months after the issuance of these regulations in final form, except as otherwise provided in this paragraph (f).

(2) *Collectively bargained plans*. In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers in effect on the date described in paragraph (f)(1) of this section, the provisions of this section and §§1.401(k)–2 through 1.401(k)–6 apply to the later of the first plan year beginning after the termination of the last such agreement or the plan year described in paragraph (f)(1) of this section.

§1.401(k)–2 ADP test.

(a) *Actual deferral percentage (ADP) test*—(1) *In general*—(i) *ADP test formula*. A cash or deferred arrangement satisfies the ADP test for a plan year only if—

(A) The ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ADP for the eligible HCEs for the plan year over the ADP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ADP for the eligible HCEs for the plan year is not more than the ADP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees*. If, for the applicable year for determining the ADP of the NHCEs for a plan year, there are no eligible NHCEs (*i.e.*, all of the eligible employees under the cash or deferred arrangement for the applicable year are HCEs), the arrangement is deemed to satisfy the ADP test for the plan year.

(iii) *Special rule for early participation*. If a cash or deferred arrangement provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the cash or deferred arrangement meets the requirements of section 410(b)(1), then in determining whether the arrangement meets the requirements under paragraph (a)(1) of this section, either—

(A) Pursuant to section 401(k)(3)(F), the ADP test is performed under the plan (determined without regard to disaggregation under §1.410(b)–7(c)(3)), using the ADP for all eligible HCEs for the plan year and the ADP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(k)–1(b)(4), the plan is disaggregated into separate plans and the ADP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ADP*—(i) *General rule*. The ADP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ADRs of the eligible employees in that group for that year.

The ADP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method*. The ADP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ADP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ADP test is being performed. Under the prior year testing method, the ADP for the eligible NHCEs is determined using the ADRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ADP test is being calculated. Under the current year testing method, the applicable year for determining the ADP for the eligible NHCEs is the same plan year as the plan year for which the ADP test is being performed. Under either method, the ADP for eligible HCEs is the average of the ADRs of the eligible HCEs for the plan year for which the ADP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ADR*—(i) *General rule*. The ADR of an eligible employee for a plan year or applicable year is the sum of the employee's elective contributions taken into account with respect to such employee for the year, determined under the rules of paragraphs (a)(4) and (5) of this section, and the qualified nonelective contributions and qualified matching contributions taken into account with respect to such employee under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ADR is calculated to the nearest hundredth of a percentage point. If no elective contributions, qualified nonelective contributions, or qualified matching contributions are taken into account under this section with respect to an eligible employee for the year, the ADR of the employee is zero.

(ii) *ADR of HCEs eligible under more than one arrangement*—(A) *General rule*. Pursuant to section 401(k)(3)(A), the ADR of an HCE who is an eligible employee in more than one cash or deferred arrangement of the same employer is calculated by treating all contributions with respect to such HCE under any such arrangement as being made under the cash or deferred arrangement being tested. Thus, the ADR for such an HCE is calculated by accumulating all contributions under any cash or deferred arrangement (other than a cash or deferred arrangement described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the cash or deferred arrangement under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ADR for the plan year of that plan for an HCE who participates in multiple cash or deferred arrangements of the same employer is the sum of all contributions during such 12-month period that would be taken into account with respect to the HCE under all such arrangements in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(k)–3.

(B) *Plans not permitted to be aggregated*. Cash or deferred arrangements under plans that are not permitted to be aggregated under §1.401(k)–1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(k)–1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)–7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Examples*. The following examples illustrate the application of this paragraph (a)(3):

Example 1. (i) Employee A, an HCE with compensation of $120,000, is eligible to make elective contributions under Plan S and Plan T, two profit-sharing plans maintained by Employer H with calendar year plan years, each of which includes a cash or deferred arrangement. During the current plan year, Employee A makes elective contributions of $6,000 to Plan S and $4,000 to Plan T.

(ii) Under each plan, the ADR for Employee A is determined by dividing Employee A's total elective contributions under both arrangements by Employee A's compensation taken into account under the plan for the year. Therefore, Employee A's ADR under each plan is 8.33% ($10,000/$120,000).

Example 2. (i) The facts are the same as in *Example 1*, except that Plan T defines compensation (for deferral and testing purposes) to exclude all bonuses paid to an employee. Plan S defines compensation (for deferral and testing purposes) to include bonuses paid to an employee. During the current year, Employee A's compensation included a $10,000 bonus. Therefore, Employee A's compensation under Plan T is $110,000 and Employee A's compensation under Plan S is $120,000.

(ii) Employee A's ADR under Plan T is 9.09% ($10,000/$110,000) and under Plan S, Employee A's ADR is 8.33% ($10,000/$120,000).

Example 3. (i) Employer J sponsors two profit-sharing plans, Plan U and Plan V, each of which includes a cash or deferred arrangement. Plan U's plan year begins on July 1 and ends on June 30. Plan V has a calendar year plan year. Compensation under both plans is limited to the participant's compensation during the period of participation. Employee B is an HCE who participates in both plans. Employee B's monthly compensation and elective contributions to each plan for the 2005 and 2006 calendar years are as follows:

Calendar year	Monthly Compensation	Monthly Elective Contribution to Plan U	Monthly Elective Contribution to Plan V
2005	$10,000	$500	$400
2006	$11,500	$700	$550

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and Plan V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($900 x 6) + ($1,250 x 6)) / (($10,000 x 6) + ($11,500 x 6)), or 10%.

(iii) Under Plan V, Employee B's ADR for the plan year ended December 31, 2005, is equal to total elective contributions under Plan U and V for the plan year ending December 31, 2005, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan V for the plan year ending December 31, 2005, is ($10,800/$120,000), or 9%.

Example 4. (i) The facts are the same as *Example 3*, except that Employee B first becomes eligible to participate in Plan U on January 1, 2006.

(ii) Under Plan U, Employee B's ADR for the plan year ended June 30, 2006, is equal to Employee B's total elective contributions under Plan U and V for the plan year ending June 30, 2006, divided by Employee B's compensation for that period. Therefore, Employee B's ADR under Plan U for the plan year ending June 30, 2006, is (($400 x 6)+ ($1,250 x 6)) / (($10,000 x 6) + ($11,500 x 6)), or 7.67%.

(4) *Elective contributions taken into account under the ADP test*—(i) *General rule*. An elective contribution is taken into account in determining the ADR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied:

(A) The elective contribution is allocated to the eligible employee's account under the plan as of a date within that year. For purposes of this rule, an elective contribution is considered allocated as of a date within a year only if—

(*1*) The allocation is not contingent on the employee's participation in the plan or performance of services on any date subsequent to that date; and

(*2*) The elective contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year to which the contribution relates.

(B) The elective contribution relates to compensation that either—

(*1*) Would have been received by the employee in the year but for the employee's election to defer under the arrangement; or

(*2*) Is attributable to services performed by the employee in the year and, but for the employee's election to defer, would have been received by the employee within 2½ months after the close of the year, but only if the plan so provides for elective contributions that relate to compensation that would have been received after the close of a year to be allocated to such prior year rather than the year in which the compensation would have been received.

(ii) *Elective contributions for partners and self-employed individuals*. For purposes of this paragraph (a)(4), a partner's distributive share of partnership income is treated as received on the last day of the partnership taxable year and a sole proprietor's compensation is treated as received on the last day of the individual's taxable year. Thus, an elective contribution made on behalf of a partner or sole proprietor is treated as allocated to the partner's account for the plan year that includes the last day of the partnership taxable year, provided the requirements of paragraph (a)(4)(i) of this section are met.

(iii) *Elective contributions for HCEs*. Elective contributions of an HCE must include any excess deferrals, as described in §1.402(g)–1(a), even if those excess deferrals are distributed, pursuant to §1.402(g)–1(e).

(5) *Elective contributions not taken into account under the ADP test*—(i) *General rule*. Elective contributions that do not satisfy the requirements of paragraph (a)(4)(i) of this section may not be taken into account in determining the ADR of an eligible employee for the plan year or applicable year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the elective contributions must satisfy the requirements of section 401(a)(4) (without regard to the ADP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Elective contributions for NHCEs*. Elective contributions of an NHCE shall not include any excess deferrals, as described in §1.402(g)–1(a), to the extent the excess deferrals are prohibited under section 401(a)(30). However, to the extent that the excess deferrals are not prohibited under section 401(a)(30), they are included in elective contributions even if distributed pursuant to §1.402(g)–1(e).

(iii) *Elective contributions treated as catch-up contributions*. Elective contributions that are treated as catch-up contributions under section 414(v) because they exceed a statutory limit or employer-provided limit (within the meaning of §1.414(v)–1(b)(1)) are not taken into account under paragraph (a)(4) of this section for the plan year for which the contributions were made, or for any other plan year.

(iv) *Elective contributions used to satisfy the ACP test*. Except to the extent necessary to demonstrate satisfaction of the requirement of §1.401(m)–2(a)(6)(ii), elective contributions taken into account for the ACP test under §1.401(m)–2(a)(6) are not taken into account under paragraph (a)(4) of this section.

(6) *Qualified nonelective contributions and qualified matching contributions that may be taken into account under the ADP test*. Qualified nonelective contributions and qualified matching contributions may be taken into account in determining the ADR for an eligible employee for a plan year or applicable year but only to the extent the contributions satisfy the following requirements.

(i) *Timing of allocation*. The qualified nonelective contribution or qualified matching contribution is allocated to the employee's account as of a date within that year within the meaning of paragraph (a)(4)(i)(A) of this section. Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP for the eligible NHCEs for the applicable year, a qualified nonelective contribution or qualified matching contribution must be contributed no later than the end of the 12-month period immediately following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Requirement that amount satisfy section 401(a)(4)*. The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). The amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ACP test of section 401(m)(2) under §1.401(m)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the cash or deferred arrangement, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(ii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iii) *Aggregation must be permitted*. The plan that contains the cash or deferred arrangement and the plan or plans to which the qualified nonelective contributions or qualified matching contributions are made, are plans that would be permitted to be aggregated under §1.401(k)–1(b)(4). If the plan year of the plan that contains the cash or deferred arrangement is changed to satisfy the requirement under §1.410(b)–7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and qualified matching contributions may be taken into account in the resulting short plan year only if such qualified nonelective contributions and qualified matching contributions could have been taken into account under an ADP test for a plan with the same short plan year.

(iv) *Disproportionate contributions not taken into account*—(A) *General rule*. Qualified nonelective contributions cannot be taken into account for a plan year for an NHCE to the extent such contributions exceed the product of that NHCE's compensation and the greater of 5% or two times the plan's representative contribution rate. Any qualified nonelective contribution taken into account under an ACP test under §1.401(m)–2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(m)–2(a)(6)(v)(B)), is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate under paragraph (a)(6)(iv)(B) of this section).

(B) *Definition of representative contribution rate*. For purposes of this paragraph (a)(6)(iv), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the plan year and who is employed by the employer on the last day of the plan year).

(C) *Definition of applicable contribution rate*. For purposes of this paragraph (a)(6)(iv), the applicable contribution rate for an eligible NHCE is the sum of the qualified matching contributions taken into account under this paragraph (a)(6) for the eligible NHCE for the plan year and the qualified nonelective contributions made for that eligible NHCE for the plan year, divided by that eligible NHCE's compensation for the same period.

(v) *Qualified matching contributions*. Qualified matching contributions satisfy this paragraph (a)(6) only to the extent that such qualified matching contributions are matching contributions that are not precluded from being taken into account under the ACP test for the plan year under the rules of §1.401(m)–2(a)(5)(ii).

(vi) *Contributions only used once*. Qualified nonelective contributions and qualified matching contributions can not be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ADP test, any ACP test, or the requirements of §1.401(k)–3, 1.401(m)–3 or 1.401(k)–4. Thus, for example, matching contributions that are made pursuant to §1.401(k)–3(c) cannot be taken into account under the ADP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(k)–2(c), qualified nonelective contributions that are taken into account under the current year testing method for a year may not be taken into account under the prior year testing method for the next year.

(7) *Examples*. The following examples illustrate the application of this paragraph (a):

Example 1. (i) Employer X has three employees, A, B, and C. Employer X sponsors a profit-sharing plan (Plan Z) that includes a cash or deferred arrangement. Each year, Employer X determines a bonus attributable to the prior year. Under the cash or deferred arrangement, each eligible employee may elect to receive none, all or any part of the bonus in cash. X contributes the remainder to Plan Z. The portion of the bonus paid in cash, if any, is paid 2 months after the end of the plan year and thus is included in compensation for the following plan year. Employee A is an HCE, while Employees B and C are NHCEs. The plan uses the current year testing method and defines compensation to include elective contributions and bonuses paid during each plan year. In February of 2005, Employer X determined that no bonuses will be paid for 2004. In February of 2006, Employer X provided a bonus for each employee equal to 10% of regular compensation for 2005. For the 2005 plan year, A, B, and C have the following compensation and make the following elections:

Employee	Compensation	Elective Contribution
A	$100,000	$4,340
B	60,000	2,860
C	45,000	1,250

(ii) For each employee, the ratio of elective contributions to the employee's compensation for the plan year is:

Employee	Ratio of Elective Contribution to Compensation	ADR
A	$4,340/$100,000	4.34%
B	2,860/60,000	4.77
C	1,250/45,000	2.78

(iii) The ADP for the HCEs (Employee A) is 4.34%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 4.34% is less than 4.73% (3.78% multiplied by 1.25), the plan satisfies the ADP test under paragraph (a)(1)(i) of this section.

Example 2. (i) The facts are the same as in *Example 1*, except that elective contributions are made pursuant to a salary reduction agreement throughout the plan year, and no bonuses are paid. As provided by section 414(s)(2), Employer X includes elective contributions in compensation. During the year, B and C defer the same amount as in *Example 1*, but A defers $5,770. Thus, the compensation and elective contributions for A, B, and C are:

Employee	Gross Compensation	Elective Contributions	ADR
A	$100,000	$5,770	5.77%
B	60,000	2,860	4.77
C	45,000	1,250	2.78

(ii) The ADP for the HCEs (Employee A) is 5.77%. The ADP for the NHCEs is 3.78% ((4.77% + 2.78%)/2). Because 5.77% exceeds 4.73% (3.78% x 1.25), the plan does not satisfy the ADP test under paragraph (a)(1)(i) of this section. However, because the ADP for the HCEs does not exceed the ADP for the NHCEs by more than 2 percentage points and the ADP for the HCEs does not exceed the ADP for the NHCEs multiplied by 2 (3.78% x 2 = 7.56%), the plan satisfies the ADP test under paragraph (a)(1)(ii) of this section.

Example 3. (i) Employees D through L are eligible employees in Plan T, a profit-sharing plan that contains a cash or deferred arrangement. The plan is a calendar year plan that uses the prior year testing method. Plan T provides that elective contributions are included in compensation (as provided under section 414(s)(2)). Each eligible employee may elect to defer up to 6% of compensation under the cash or deferred arrangement. Employees D and E are HCEs. The compensation, elective contributions, and ADRs of Employees D and E for the 2006 plan year are shown below:

Employee	Compensation for 2006 Plan Year	Elective Contributions for 2006 Plan Year	ADR for 2006 Plan Year
D	$100,000	$10,000	10%
E	$95,000	$4,750	5%

(ii) During the 2005 plan year, Employees F through L were eligible NHCEs. The compensation, elective contributions and ADRs of Employees F through L for the 2005 plan year are shown in the following table:

Employee	Compensation for 2005 Plan Year	Elective Contributions for 2005 Plan Year	ADR for 2005 Plan Year
F	$60,000	$3,600	6%
G	$40,000	$1,600	4%
H	$30,000	$1,200	4%
I	$20,000	$600	3%
J	$20,000	$600	3%
K	$10,000	$300	3%
L	$5,000	$150	3%

(iii) The ADP for 2006 for the HCEs is 7.5%. Because Plan T is using the prior year testing method, the applicable year for determining the NHCE ADP is the prior plan year (*i.e.*, 2005). The NHCE ADP is determined using the ADRs for NHCEs eligible during the prior plan year (without regard to whether they are eligible under the plan during the plan year). The ADP for the NHCEs is 3.71% (the sum of the individual ADRs, 26%, divided by 7 employees). Because 7.5% exceeds 4.64% (3.71% x 1.25), Plan T does not satisfy the ADP test under paragraph (a)(1)(i) of this section. In addition, because the ADP for the HCEs exceeds the ADP for the NHCEs by more than 2 percentage points, Plan T does not satisfy the ADP test under paragraph (a)(1)(ii) of this section. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 4. (i) Plan U is a calendar year profit-sharing plan that contains a cash or deferred arrangement and uses the current year testing method. Plan U provides that elective contributions are included in compensation (as provided under section 414(s)(2)). The following amounts are contributed under Plan U for the 2006 plan year: (A) QNECs equal to 2% of each employee's compensation; (B) Contributions equal to 6% of each employee's compensation that are not immediately vested under the terms of the plan; (C) 3% of each employee's compensation that the employee may elect to receive as cash or to defer under the plan. Both types of nonelective contributions are made for the HCEs (employees M and N) and the NHCEs (employees O through S) for the plan year and are contributed after the end of the plan year and before the end of the following plan year. In addition, neither type of nonelective contributions is used for any other ADP or ACP test.

(ii) For the 2006 plan year, the compensation, elective contributions, and actual deferral ratios of employees M through S are shown in the following table:

Employee	Compensation	Elective Contributions	Actual Deferral Ratio
M	$100,000	$3,000	3%
N	$100,000	$2,000	2%
O	$60,000	$1,800	3%
P	$40,000	0	0
Q	$30,000	0	0
R	$5,000	0	0
S	$20,000	0	0

(iii) The elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section because the ADP for the HCEs, consisting of employees M and N, is 2.5% and the ADP for the NHCEs is 0.6%.

(iv) The 2% QNECs satisfies the timing requirement of paragraph (a)(6)(i) of this section because it is paid within 12-month after the plan year for which allocated. All nonelective contributions also satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section (because all employees receive an 8% nonelective contribution and the nonelective contributions excluding the QNECs is 6% for all employees). In addition, the QNECs are not disproportionate under paragraph (a)(6)(iv) of this section because no QNEC for an NHCE exceeds the product of the plan's applicable contribution rate (2%) and that NHCE's compensation.

(v) Because the rules of paragraph (a)(6) of this section are satisfied, the 2% QNECs may be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section. The 6% nonelective contributions, however, may not be taken into account because they are not QNECs.

(vi) If the 2% QNECs are taken into account, the ADP for the HCEs is 4.5%, and the actual deferral percentage for the NHCEs is 2.6%. Because 4.5% is not more than two percentage points greater than 2.6 percent, and not more than two times 2.6, the cash or deferred arrangement satisfies the ADP test of section 401(k)(3) under paragraph (a)(1)(ii) of this section.

Example 5. (i) The facts are the same as *Example 4*, except the plan uses the prior year testing method. In addition, the NHCE ADP for the 2005 plan year (the prior plan year) is 0.8% and no QNECs are contributed for the 2005 plan year during 2005 or 2006.

(ii) In 2007, it is determined that the elective contributions alone do not satisfy the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for 2006 because the 2006 ADP for the eligible HCEs, consisting of employees M and N, is 2.5% and the 2005 ADP for the eligible NHCEs is 0.8%. An additional QNEC of 2% of compensation is made for each eligible NHCE in 2007 and allocated for 2005.

(iii) The 2% QNECs that are made in 2007 and allocated for the 2005 plan year do not satisfy the timing requirement of paragraph (a)(6)(i) of this section for the applicable year for the 2005 plan year because they were not contributed before the last day of the 2006 plan year. Accordingly, the 2% QNECs do not satisfy the rules of paragraph (a)(6) of this section and may not be taken into account in applying the ADP test of section 401(k)(3) and paragraph (a)(1) of this section for the 2006 plan year. The cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as *Example 4*, except that the ADP for the HCEs is 4.6% and there is no 6% nonelective contribution under the plan. The employer would like to take into account the 2% QNEC in determining the ADP for the NHCEs but not in determining the ADP for the HCEs.

(ii) The elective contributions alone fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (4.6%) exceeds 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2).

(iii) The 2% QNECs may not be taken into account in determining the ADP of the NHCEs because they fail to satisfy the requirements relating to section 401(a)(4) set forth in paragraph (a)(6)(ii) of this section. This is because the amount of nonelective contributions, excluding those QNECs that would be taken into account under the ADP test, would be 2% of compensation for the HCEs and 0% for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 7. (i) The facts are the same as *Example 6*, except that Employee R receives a QNEC in an amount of $500 and no QNECs are made on behalf of the other employees.

(ii) If the QNEC could be taken into account under paragraph (a)(6) of this section, the ADP for the NHCEs would be 2.6% and the plan would satisfy the ADP test. The QNEC is disproportionate under paragraph (a)(6)(iv) of this section, and cannot be taken into account under paragraph (a)(6) of this section, to the extent it exceeds the greater of 5% and two times the plan's representative contribution rate (0%), multiplied by Employee R's compensation. The plan's representative contribution rate is 0% because it is the lowest applicable contribution rate among a group of NHCEs that is at least half of all NHCEs, or all the NHCEs who are employed on the last day of the plan year. Therefore, the QNEC may be taken into account under the ADP test only to the extent it does not exceed 5% times Employee R's compensation (or $250) and the cash or deferred arrangement fails to satisfy the ADP test and must correct under paragraph (b) of this section.

Example 8. (i) The facts are the same as in *Example 4* except that the plan changes from the current year testing method to the prior year testing method for the following plan year (2006 plan year). The ADP for the HCEs for the 2006 plan year is 3.5%.

(ii) The 2% QNECs may not be taken into account in determining the ADP for the NHCEs for the applicable year (2005 plan year) in satisfying the ADP test for the 2006 plan year because they were taken into account in satisfying the ADP test for the 2005 plan year. Accordingly, the NHCE ADP for the applicable year is 0.6%. The elective contributions for the plan year fail the requirements of section 401(k) and paragraph (a)(1) of this section because the HCE ADP for the plan year (3.5%) exceeds the ADP limit of 1.2% (the greater of 0.75% (0.6% x 1.25) and 1.2% (0.6% x 2)), determined using the applicable year ADP for the NHCEs. Therefore, the cash or deferred arrangement fails to be a qualified cash or deferred arrangement unless the ADP failure is corrected under paragraph (b) of this section.

Example 9. (i)(A) Employer N maintains Plan X, a profit sharing plan that contains a cash or deferred arrangement and that uses the current year testing method. Plan X provides for employee contributions, elective contributions, and matching contributions. Matching contributions on behalf of nonhighly compensated employees are qualified matching contributions (QMACs) and are contributed during the 2005 plan year. Matching contributions on behalf of highly compensated employees are not QMACs, because they fail to satisfy the nonforfeitability requirement of §1.401(k)–1(c). The elective contributions and matching contributions with respect to HCEs for the 2005 plan year are shown in the following table:

	Elective Contributions	Total Matching Contributions	Matching contributions that are not QMACs	QMACs
Highly compensated employees	15%	5%	5%	0%

(B) The elective contributions and matching contributions with respect to the NHCEs for the 2005 plan year are shown in the following table:

	Elective Contributions	Total Matching Contributions	Matching contributions that are not QMACs	QMACs
Nonhighly compensated employees	11%	4%	0%	4%

(ii) The plan fails to satisfy the ADP test of section 401(k)(3)(A) and paragraph (a)(1) of this section because the ADP for HCEs (15%) is more than 125% of the ADP for NHCEs (11%), and more than 2 percentage points greater than 11%. However, the plan provides that QMACs may be used to meet the requirements of section 401(k)(3)(A)(ii) provided that they are not used for any other ADP or ACP test. QMACs equal to 1% of compensation are taken into account for each NHCE in applying the ADP test. After this adjustment, the applicable ADP and ACP (taking into account the provisions of §1.401(m)–2(a)(5)(ii)) for the plan year are as follows:

	Actual Deferral Percentage	Actual Contribution Percentage
HCEs	15%	5%
Nonhighly compensated employees	12%	3%

(iii) The elective contributions and QMACs taken into account for purposes of the ADP test of section 401(k)(3) satisfy the requirements of section 401(k)(3)(A)(ii) under paragraph (a)(1)(ii) of this section because the ADP for HCEs (15%) is not more than the ADP for NHCEs multiplied by 1.25 (12% x 1.25 = 15%).

(b) *Correction of excess contributions*—(1) *Permissible correction methods*—(i) *In general*. A cash or deferred arrangement does not fail to satisfy the requirements of section 401(k)(3) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan that includes the cash or deferred arrangement, uses any of the following correction methods—

(A) *Qualified nonelective contributions or qualified matching contributions*. The employer makes qualified nonelective contributions or qualified matching contributions that are taken into account under this section and, in combination with other amounts taken into account under paragraph (a) of this section, allow the cash or deferred arrangement to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess contributions distributed*. Excess contributions are distributed in accordance with paragraph (b)(2) of this section.

(C) *Excess contributions recharacterized*. Excess contributions are recharacterized in accordance with paragraph (b)(3) of this section.

(ii) *Combination of correction methods*. A plan may provide for the use of any of the correction methods described in paragraph (b)(1)(i) of this section, may limit elective contributions in a manner designed to prevent excess contributions from being made, or may use a combination of these methods, to avoid or correct excess contributions. A plan may require or permit an HCE to elect whether any excess contributions are to be recharacterized or distributed. If the plan uses a combination of correction methods, any contribution made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction methods in paragraph (b)(1)(i)(B) or (C) of this section.

(iii) *Exclusive means of correction*. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than the ones described in paragraphs (b)(1)(i) and (ii) of this section. Thus, excess contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5).

(2) *Corrections through distribution*—(i) *General rule*. This paragraph (b)(2) contains the rules for correction of excess contributions through a distribution from the plan. Correction through a distribution generally involves a 4 step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess contributions among HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned excess contributions and allocable income in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions. Paragraph (b)(2)(vii) provides other rules relating to these distributions.

(ii) *Calculation of total amount to be distributed*. The following procedures must be used to determine the total amount of the excess contributions to be distributed—

(A) *Calculate the dollar amount of excess contributions for each HCE*. The amount of excess contributions attributable to a given HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ADR to equal the highest permitted ADR under the plan. To calculate the highest permitted ADR under a plan, the ADR of the HCE with the highest ADR is reduced by the amount required to cause that HCE's ADR to equal the ADR of the HCE with the next highest ADR. If a lesser reduction would enable the arrangement to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction is used in determining the highest permitted ADR.

(B) *Determination of the total amount of excess contributions*. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the arrangement would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess contributions for the plan year.

(C) *Satisfaction of ADP*. A cash or deferred arrangement satisfies this paragraph (b)(2)(ii)(C) if the arrangement would satisfy the requirements of paragraph (a)(1)(ii) of this section if the ADR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess contributions among the HCEs*. The following procedures must be used in apportioning the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section among the HCEs:

(A) *Calculate the dollar amount of excess contributions for each HCE*. The contributions of the HCE with the highest dollar amount of contributions taken into account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of the contributions taken into account under this section for the HCE with the next highest dollar amount of contributions taken into account under this section. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any individual*. For purposes of this paragraph (b)(2)(iii), the amount of contributions taken into account under this section with respect to an HCE who is an eligible employee in more than one plan of an employer is determined by taking into account all contributions otherwise taken into account with respect to such HCE under any plan of the employer during the plan year of the plan being tested as being made under the plan being tested. However, the amount of excess contributions apportioned for a plan year with respect to any HCE must not exceed the amount of contributions actually contributed to the plan for the HCE for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which elective contributions are made and whose ADR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount required to be distributed under this paragraph (b)(2)(iii) shall not exceed the contributions actually contributed to the plan and taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs*. The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess contributions determined under paragraph (b)(2)(ii) of this section have been apportioned.

(iv) *Income allocable to excess contributions*—(A) *General rule*. The income allocable to excess contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (gap period), the allocable gain or loss for the gap period.

(B) *Method of allocating income*. A plan may use any reasonable method for computing the income allocable to excess contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participant's accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating plan year income*. A plan may allocate income to excess contributions for the plan year by multiplying the income for the plan year allocable to the elective contributions and other amounts taken into account under this section (including contributions made for the plan year), by a fraction, the numerator of which is the excess contributions for the employee for the plan year, and the denominator of which is the account balance attributable to elective contributions and other contributions taken into account under this section as of the beginning of the plan year (including any additional amount of such contributions made for the plan year).

(D) *Safe harbor method of allocating gap period income*. A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess contributions for the gap period. Under this safe harbor method, income on excess contributions for the gap period is equal to 10% of the income allocable to excess contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) *Alternative method for allocating plan year and gap period income*. A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to this aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken account under this section for the plan year in determining the fraction that is multiplied by that income.

(v) *Distribution*. Within 12 months after the close of the plan year in which the excess contribution arose, the plan must distribute to each HCE the excess contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section and the allocable income. Except as otherwise provided in this paragraph (b)(2)(v) and paragraph (b)(4)(i) of this section, a distribution of excess contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) *Tax treatment of corrective distributions*—(A) *General rule*. Except as provided in paragraph (b)(2)(vi)(B) of this section, a corrective distribution of excess contributions (and income) that is made within 2½ months after the end of the plan year for which the excess contributions were made is includible in the employee's gross income on the earliest date any elective contributions by the employee during the plan year would have been received by the employee had the employee originally elected to receive the amounts in cash. A corrective distribution of excess contributions (and income) that is made more than 2½ months after the end of the plan year for which the contributions were made is includible in the employee's gross income in the employee's taxable year in which distributed. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2½ months after the end of the plan year. See also §1.402(c)–2, A–4 for restrictions on rolling over distributions that are excess contributions.

(B) *Rule for de minimis distributions*. If the total amount of excess contributions, determined under this paragraph (b)(2), and excess aggregate contributions determined under §1.401(m)–2(b)(2) distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess contributions (and income) is includible in the gross income of the recipient in the taxable year of the recipient in which the corrective distribution is made.

(vii) *Other rules*—(A) *No employee or spousal consent required*. A corrective distribution of excess contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(B) *Treatment of corrective distributions as elective contributions*. Excess contributions are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan.

(C) *No reduction of required minimum distribution*. A distribution of excess contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)–5, Q&A–9(b).

(D) *Partial distributions*. Any distribution of less than the entire amount of excess contributions (and allocable income) with respect to any HCE is treated as a *pro rata* distribution of excess contributions and allocable income.

(viii) *Examples*. The following examples illustrate the application of this paragraph (b)(2). For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Plan P, a calendar year profit-sharing plan that includes a cash or deferred arrangement, provides for distribution of excess contributions to HCEs to the extent necessary to satisfy the ADP test. Employee A, an HCE, has elective contributions of $12,000 and $200,000 in compensation, for an ADR of 6%, and Employee B, a second HCE, has elective contributions of $8,960 and compensation of $128,000, for an ADR of 7%. The ADP for the NHCEs is 3%. Under the ADP test, the ADP of the two HCEs under the plan may not exceed 5% (*i.e.*, 2 percentage points more than the ADP of the NHCEs under the plan). The ADP for the 2 HCEs under the plan is 6.5%. Therefore, there must be a correction of excess contributions.

(ii) The total amount of excess contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the elective contributions of Employee B (the HCE with the highest ADR) are reduced by $1,280 in order to reduce his ADR to 6% ($7,680/$128,000), which is the ADR of Employee A.

(iii) Because the ADP of the HCEs determined after the $1,280 reduction to Employee B still exceeds 5%, further reductions in elective contributions are necessary in order to reduce the ADP of the HCEs to 5%. The elective contributions of Employee A and Employee B are each reduced by 1% of compensation ($2,000 and $1,280 respectively). Because the ADP of the HCEs determined after the reductions equals 5%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions).

(v) Because the total amount of excess contributions has not been apportioned, further apportionment is necessary. The balance ($1,520) of the total amount of excess contributions is apportioned equally among Employee A and Employee B ($760 to each).

(vi) Therefore, the cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,800 ($3,040 + $760) and allocable income and Employee B receives a corrective distribution of $760 and allocable income.

Example 2. (i) The facts are the same as in *Example 1*, except Employee A's ADR is based on $3,000 of elective contributions to this plan and $9,000 of elective contributions to another plan of the employer.

(ii) The total amount of excess contributions ($4,560 = $1,280+$2,000+$1,280) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of elective contributions. The amount of elective contributions for Employee A is $12,000. Therefore, Employee A is apportioned $3,040 (the amount required to cause Employee A's elective contributions to equal the next highest dollar amount of elective contributions). However, pursuant to paragraph (b)(2)(iii)(B) of this section, no more than the amount actually contributed to the plan may be apportioned to an HCE. Accordingly, no more than $3,000 may be apportioned to Employee A. Therefore, the remaining $1,560 must be apportioned to Employee B.

(ii) The cash or deferred arrangement will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess contributions equal to $3,000 (total amount of elective contributions actually contributed to the plan for Employee A) and allocable income and Employee B receives a corrective distribution of $1,560 and allocable income.

Example 3. (i) The facts are the same as in *Example 1.* The plan allocates income on a daily basis. The corrective distributions are made in February 2007. The excess contribution that must be distributed to Employee A as a corrective distribution is $3,800. This amount must be increased (or decreased) to reflect gains (or losses) allocable to that amount during the 2006 plan year. The plan uses a reasonable method that satisfies paragraph (b)(2)(iv)(B) of this section to determine the gain during the 2006 plan year allocable to the $3,800 as $145. Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required would be $3,945.

(ii) Because the plan allocates income on a daily basis, excess contributions are credited with gain or loss during the gap period. Therefore, the corrective distribution must include income allocable to $3,945 through the date of distribution. For the period from January 1 through the date of distribution, the income allocable to $3,945 is $105. Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,050.

Example 4. (i) The facts are the same as in *Example 1.* The plan determines plan year income using the alternative method for calculating income provided in paragraph (b)(2)(iv)(C) of this section and using the portion of the participant's account attributable to elective contributions, including elective contributions made for the plan year. The plan uses the safe harbor method provided in paragraph (b)(2)(iv)(D) of this section for allocating gap period income. The corrective distribution is made during the last week of February 2007. At the beginning of the 2006 plan year, $100,000 of Employee A's plan account was attributable to elective contributions. During the 2006 plan year, $10,000 in elective contributions were contributed to the plan for Employee A. The income allocable to Employee A's account attributable to elective contributions for the 2006 plan year is $8,000.

(ii) Therefore, the plan year income allocable to the $3,800 corrective distribution for Employee A is $266.65 ($8,000 multiplied by $3,800 divided by $110,000). Therefore, as of the end of the 2006 plan year, the amount of corrective distribution that is required is $4,066.65. This amount must be increased by the gap period income of $53.32 (10% multiplied by $266.65 (2006 plan year income attributable to the excess contribution) multiplied by 2 (number of calendar months since end of 2006 plan year). Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,119.97.

Example 5. (i) The facts are the same as in *Example 4*, except that the plan provides for quarterly valuations based on the account balance at the end of the quarter.

(ii) Because the plan's method for allocating income does not allocate any income to amounts distributed during the quarter, Employee A will not be credited with an allocation of income with respect to the amount distributed. Accordingly, Plan P need not plan adjust the distribution of excess contribution for income during the gap period and thus satisfies paragraph (a)(1) of this section if Employee A receives a corrective distribution of $4,066.65.

(3) *Recharacterization of excess contributions*—(i) *General rule*. Excess contributions are recharacterized in accordance with this paragraph (b)(3) only if the excess contributions that would have to be distributed under (b)(2) of this section if the plan was correcting through distribution of excess contributions are recharacterized as described in paragraph (b)(3)(ii) of this section, and all of the conditions set forth in paragraph (b)(3)(iii) of this section are satisfied.

(ii) *Treatment of recharacterized excess contributions*. Recharacterized excess contributions are includible in the employee's gross income as if such amounts were distributed under paragraph (b)(2) of this section. The recharacterized excess contributions must be treated as employee contributions for purposes of section 72, sections 401(a)(4) and 401(m). This requirement is not treated as satisfied unless the payor or plan administrator reports the recharacterized excess contributions as employee contributions to the Internal Revenue Service and the employee by timely providing such federal tax forms and accompanying instructions and timely taking such other action as prescribed by the Commissioner in revenue rulings, notices and other guidance published in the Internal Revenue Bulletin (see 601.601(d)(2) of this chapter) as well as the applicable federal tax forms and accompanying instructions.

(iii) *Additional rules*—(A) *Time of recharacterization*. Excess contributions may not be recharacterized under this paragraph (b)(3) after 2½ months after the close of the plan year to which the recharacterization relates. Recharacterization is deemed to have occurred on the date on which the last of those HCEs with excess contributions to be recharacterized is notified in accordance with paragraph (b)(3)(ii) of this section.

(B) *Employee contributions must be permitted under plan*. The amount of recharacterized excess contributions, in combination with the employee contributions actually made by the HCE, may not exceed the maximum amount of employee contributions (determined without regard to the ACP test of section 401(m)(2)) permitted under the provisions of the plan as in effect on the first day of the plan year.

(C) *Treatment of recharacterized excess contributions*. Recharacterized excess contributions continue to be treated as employer contributions for all other purposes under the Internal Revenue Code, including sections 401(a) (other than sections 401(a)(4) and 401(m)), 404, 409, 411, 412, 415, 416, and 417. Thus, for example, recharacterized excess contributions remain subject to the requirements of §1.401(k)–1(c) and (d); must be deducted under section 404; and are treated as employer contributions described in section 415(c)(2)(A) and §1.415–6(b).

(4) *Rules applicable to all corrections*—(i) *Coordination with distribution of excess deferrals*—(A) *Treatment of excess deferrals that reduce excess contributions*. The amount of excess contributions (and allocable income) to be distributed under paragraph (b)(2) of this section or the amount of excess contributions recharacterized under paragraph (b)(3) of this section with respect to an employee for a plan year, is reduced by any amounts previously distributed to the employee from the plan to correct excess deferrals for the employee's taxable year ending with or within the plan year in accordance with section 402(g)(2).

(B) *Treatment of excess contributions that reduce excess deferrals*. Under §1.402(g)–1(e), the amount required to be distributed to correct an excess deferral to an employee for a taxable year is reduced by any excess contributions (and allocable income) previously distributed or excess contributions recharacterized with respect to the employee for the plan year beginning with or within the taxable year. The amount of excess contributions includible in the gross income of the employee, and the amount of excess contributions reported by the payer or plan administrator as includible in the gross income of the employee, does not include the amount of any reduction under §1.402(g)–1(e)(6).

(ii) *Forfeiture of match on distributed excess contributions*. A matching contribution is taken into account under section 401(a)(4) even if the match is with respect to an elective contribution that is distributed or recharacterized under this paragraph (b). This requires that, after correction of excess contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)–4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if elective contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(k)(3), while matching contributions attributable to those elective contributions remain allocated to the HCEs' accounts. Under section 411(a)(3)(G) and §1.411(a)–4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions or excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)–11(g)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions.

(iii) *Permitted forfeiture of QMAC*. Pursuant to section 401(k)(8)(E), a qualified matching contribution is not treated as forfeitable under §1.401(k)–1(c) merely because under the plan it is forfeited in accordance with paragraph (b)(4)(ii) of this section.

(iv) *No requirement for recalculation*. If excess contributions are distributed or recharacterized in accordance with paragraphs (b)(2) and (3) of this section, the cash or deferred arrangement is treated as meeting the nondiscrimination test of section 401(k)(3) regardless of whether the ADP for the HCEs, if recalculated after the distributions or recharacterizations, would satisfy section 401(k)(3).

(v) *Treatment of excess contributions that are catch-up contributions*. A cash or deferred arrangement does not fail to meet the requirements of section 401(k)(3) and paragraph (a)(1) of this section merely because excess contributions that are catch-up contributions because they exceed the ADP limit, as described in §1.414(v)–1(b)(1)(iii), are not corrected in accordance with this paragraph (b).

(5) *Failure to timely correct*—(i) *Failure to correct within 2½ months after end of plan year*. If a plan does not correct excess contributions within 2½ months after the close of the plan year for which the excess contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess contributions. See section 4979 and §54.4979–1 of this chapter. Qualified nonelective contributions and qualified matching contributions properly taken into account under paragraph (a)(6) of this section for a plan year may enable a plan to avoid having excess contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year*. If excess contributions are not corrected within 12 months after the close of the plan year for which they were made, the cash or deferred arrangement will fail to satisfy the requirements of section 401(k)(3) for the plan year for which the excess contributions are made and all subsequent plan years during which the excess contributions remain in the trust.

(c) *Additional rules for prior year testing method*—(1) *Rules for change in testing method*—(i) *General rule*. A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in paragraph (c)(1)(ii) of this section. For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(k)–3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year.

(ii) *Situations permitting a change to the prior year testing method*. The situations described in this paragraph (c)(1)(ii) are:

(A) The plan is not the result of the aggregation of two or more plans, and the current year testing method was used under the plan for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan).

(B) The plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated (the aggregating plans), the current year testing method was used for each of the 5 plan years preceding the plan year of the change (or if lesser, the number of plan years since that aggregating plan has been in existence, including years in which the aggregating plan was a portion of another plan).

(C) A transaction described in section 410(b)(6)(C)(i) and §1.410(b)–2(f) occurs and—

(*1*) As a result of the transaction, the employer maintains both a plan using the prior year testing method and a plan using the current year testing method; and

(*2*) The change from the current year testing method to the prior year testing method occurs within the transition period described in section 410(b)(6)(C)(ii).

(2) *Calculation of ADP under the prior year testing method for the first plan year*—(i) *Plans that are not successor plans*. If, for the first plan year of any plan (other than a successor plan), the plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ADP for eligible NHCEs, or use 3% as the ADP for eligible NHCEs, for applying the ADP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting on QNECs under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined*. For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for elective contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)–7(b)) for a plan year if for such plan year the plan is aggregated under §1.401(k)–1(b)(4) with any other plan that provides for elective contributions in the prior year.

(iii) *Successor plans*. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under a qualified cash or deferred arrangement maintained by the employer in the prior year. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ADP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ADP and ACP test*. Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ADP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ACP test for that year. For example, a plan may use the prior year testing method for the ADP test and the current year testing method for its ACP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use—

(i) The recharacterization method of paragraph (b)(3) of this section to correct excess contributions for a plan year;

(ii) The rules of §1.401(m)–2(a)(6)(ii) to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph (a)(6)(v) of this section to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage changes*—(i) *In general*. A plan that uses the prior year testing method and experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ADP for the NHCEs for the plan year is the weighted average of the ADPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes*. If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ADP for the group of eligible NHCEs for the prior year under the plan is the ADP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions*. The following definitions apply for purposes of this paragraph (c)(4):

(A) *Plan coverage change*. The term plan coverage change means a change in the group or groups of eligible employees under a plan on account of—

(*1*) The establishment or amendment of a plan;

(*2*) A plan merger or spinoff under section 414(l);

(*3*) A change in the way plans (within the meaning of §1.410(b)–7(b)) are combined or separated for purposes of §1.401(k)–1(b)(4) (*e.g.*, permissively aggregating plans not previously aggregated under §1.410(b)–7(d), or ceasing to permissively aggregate plans under §1.410(b)–7(d));

(*4*) A reclassification of a substantial group of employees that has the same effect as amending the plan (*e.g.*, a transfer of a substantial group of employees from one division to another division); or

(*5*) A combination of any of paragraphs (c)(4)(iii)(A)(*1*) through (*4*) of this section.

(B) *Prior year subgroup*. The term prior year subgroup means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan maintained by the employer that included a qualified cash or deferred arrangement and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ADPs for the prior year subgroups*. The term weighted average of the ADPs for the prior year subgroups means the sum, for all prior year subgroups, of the adjusted ADPs for the plan year. The term adjusted ADP with respect to a prior year subgroup means the ADP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Examples*. The following examples illustrate the application of this paragraph (c)(4):

Example 1. (i) Employer B maintains two calendar year plans, Plan O and Plan P, each of which includes a cash or deferred arrangement. The plans were not permissively aggregated under §1.410(b)–7(d) for the 2005 plan year. Both plans use the prior year testing method. Plan O had 300 eligible employees who were NHCEs for the 2005 plan year, and their ADP for that year was 6%. Sixty of the eligible employees who were NHCEs for the 2005 plan year under Plan O, terminated their employment during that year. Plan P had 100 eligible employees who were NHCEs for 2005, and the ADP for those NHCEs for that plan was 4%. Plan O and Plan P are permissively aggregated under §1.410(b)–7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under § 1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of §1.401(k)–1(b)(4). Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) The Plan O prior year subgroup consists of the 300 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.5%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 300/400 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/400 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

(v) As provided in paragraph (c)(4)(iii)(B) of this section, the determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether that NHCE terminated employed during the prior year. Thus, the prior ADP for the NHCEs under Plan OP for the 2006 plan year is unaffected by the termination of the 60 NHCEs covered by Plan O during the 2005 plan year.

Example 2. (i) The facts are the same as *Example 1*, except that the 60 employees who terminated employment during the 2005 plan are instead spun-off to another plan.

(ii) The permissive aggregation of Plan O and Plan P for the 2006 plan year under §1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of §1.401(k)–1(b)(4) and the spin-off of the 60 employees is a plan coverage change. Therefore, the prior year ADP for the NHCEs under Plan OP for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups: the Plan O prior year subgroup and the Plan P prior year subgroup.

(iii) For purposes of determining the prior year subgroups, the employees who would have been eligible employees in the prior year under the plan being tested are determined as if both plan coverage changes had first been effective as of the first day of the prior plan year. The Plan O prior year subgroup consists of the 240 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and would have been eligible under Plan OP for the 2005 plan year if the spin-off had occurred at the beginning of the 2005 plan year and Plan O and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P and would have been eligible under Plan OP for the 2005 plan year if Plan O and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year.

(iv) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan O and the adjusted ADP with respect to the prior year subgroup consisting of eligible NHCEs from Plan P. The adjusted ADP for the prior year subgroup consisting of eligible NHCEs under Plan O is 4.23%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 240/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the prior year subgroup consisting of the eligible NHCEs from Plan P is 1.18%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/340 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan OP for the 2006 plan year is 5.41% (the sum of adjusted ADPs for the prior year subgroups, 4.23% plus 1.18%).

Example 3. (i) The facts are the same as in *Example 1*, except that instead of Plan O and Plan P being permissively aggregated for the 2006 plan year, 200 of the employees eligible under Plan O were spun-off from Plan O and merged into Plan P.

(ii) The spin-off from Plan O and merger to Plan P for the 2006 plan year are plan coverage changes for Plan P. Therefore, the prior year ADP for the NHCEs under Plan P for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan P. There are 2 subgroups under Plan P for the 2006 plan year. The Plan O prior year subgroup consists of the 200 employees who, in the 2005 plan year, were eligible NHCEs under Plan O and who would have been eligible under Plan P for the 2005 plan year if the spin-off and merger had occurred on the first day of the 2005 plan year. The Plan P prior year subgroup consists of the 100 employees who, in the 2005 plan year, were eligible NHCEs under Plan P for the 2005 plan year.

(iii) The weighted average of the ADPs for the prior year subgroups is the sum of the adjusted ADP for the Plan O prior year subgroup and the adjusted ADP for the Plan P prior year subgroup. The adjusted ADP for the Plan O prior year subgroup is 4.0%, calculated as follows: 6% (the ADP for the NHCEs under Plan O for the 2005 plan year) x 200/300 (the number of NHCEs in the Plan O prior year subgroup divided by the total number of NHCEs in all prior year subgroups). The adjusted ADP for the Plan P prior year subgroup is 1.33%, calculated as follows: 4% (the ADP for the NHCEs under Plan P for the 2005 plan year) x 100/300 (the number of NHCEs in the Plan P prior year subgroup divided by the total number of NHCEs in all prior year subgroups). Thus, the prior year ADP for NHCEs under Plan P for the 2006 plan year is 5.33% (the sum of adjusted ADPs for the 2 prior year subgroups, 4.0% plus 1.33%).

(iv) The spin-off from Plan O for the 2006 plan year is a plan coverage change for Plan O. Therefore, the prior year ADP for the NHCEs under Plan O for the 2006 plan year is the weighted average of the ADPs for the prior year subgroups under Plan O. In this case, there is only one prior year subgroup under Plan O, the employees who were NHCEs of Employer B for the 2005 plan year and who were eligible for the 2005 plan year under Plan O. Because there is only one prior year subgroup under Plan O, the weighted average of the ADPs for the prior year subgroup under Plan O is equal to the NHCE ADP for the prior year (2005 plan year) under Plan O, or 6%.

Example 4. (i) Employer C maintains a calendar year plan, Plan Q, which includes a cash or deferred arrangement that uses the prior year testing method. Plan Q covers employees of Division A and Division B. In 2005, Plan Q had 500 eligible employees who were NHCEs, and the ADP for those NHCEs for 2005 was 2%. Effective January 1, 2006, Employer C amends the eligibility provisions under Plan Q to exclude employees of Division B effective January 1, 2006. In addition, effective on that same date, Employer C establishes a new calendar year plan, Plan R, which includes a cash or deferred arrangement that uses the prior year testing method. The only eligible employees under Plan R are the 100 employees of Division B who were eligible employees under Plan Q.

(ii) Plan R is a successor plan, within the meaning of paragraph (c)(2)(iii) of this section (because all of the employees were eligible employees under Plan Q in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The amendment to the eligibility provisions of Plan Q and the establishment of Plan R are plan coverage changes within the meaning of paragraph (c)(4)(iii)(A) of this section for Plan Q and Plan R. Accordingly, each plan must determine the NHCE ADP for the 2006 plan year under the rules set forth in paragraph (c)(4) of this section.

(iv) The prior year ADP for NHCEs under Plan Q is the weighted average of the ADPs for the prior year subgroups. Plan Q has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan Q for the 2005 plan year if the amendment to the Plan Q eligibility provisions had occurred as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 plan year under Plan Q, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as if the plan amendment had not occurred.

(v) Similarly, Plan R has only one prior year subgroup (because the only NHCEs who would have been eligible employees under Plan R for the 2005 plan year if the plan were established as of the first day of that plan year were eligible employees under Plan Q). Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

Example 5. (i) The facts are the same as in *Example 4*, except that the provisions of Plan R extend eligibility to 50 hourly employees who previously were not eligible employees under any qualified cash or deferred arrangement maintained by Employer C.

(ii) Plan R is a successor plan (because 100 of Plan R's 150 eligible employees were eligible employees under another qualified cash or deferred arrangement maintained by Employer C in the prior year). Therefore, Plan R cannot use the first plan year rule set forth in paragraph (c)(2)(i) of this section.

(iii) The establishment of Plan R is a plan coverage change that affects Plan R. Because the 50 hourly employees were not eligible employees under any qualified cash or deferred arrangement of Employer C for the prior plan year, they do not comprise a prior year subgroup. Accordingly, Plan R still has only one prior year subgroup. Therefore, for purposes of the 2006 testing year under Plan R, the ADP for NHCEs for the prior year is the weighted average of the ADPs for the prior year subgroups, or 2%, the same as that of Plan Q.

§1.401(k)–3 Safe harbor requirements.

(a) *ADP test safe harbor*. A cash or deferred arrangement satisfies the ADP safe harbor provision of section 401(k)(12) for a plan year if the arrangement satisfies the safe harbor contribution requirement of paragraph (b) or (c) of this section for the plan year, the notice requirement of paragraph (d) of this section, the plan year requirements of paragraph (e) of this section, and the additional rules of paragraphs (f), (g) and (h) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraph (b) or (c) of this section must be satisfied without regard to section 401(l).

The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) *Safe harbor nonelective contribution requirement*—(1) *General rule*. The safe harbor nonelective contribution requirement of this paragraph is satisfied if, under the terms of the plan, the employer is required to make a qualified nonelective contribution on behalf of each eligible NHCE equal to at least 3% of the employee's safe harbor compensation.

(2) *Safe harbor compensation defined*. For purposes of this section, safe harbor compensation means compensation as defined in §1.401(k)–6 (which incorporates the definition of compensation in §1.414(s)–1); provided, however, that the rule in the last sentence of §1.414(s)–1(d)(2)(iii) (which generally permits a definition of compensation to exclude all compensation in excess of a specified dollar amount) does not apply in determining the safe harbor compensation of NHCEs. Thus, for example, the plan may limit the period used to determine safe harbor compensation to the eligible employee's period of participation.

(c) *Safe harbor matching contribution requirement*—(1) *In general*. The safe harbor matching contribution requirement of this paragraph (c) is satisfied if, under the plan, qualified matching contributions are made on behalf of each eligible NHCE in an amount determined under the basic matching formula of section 401(k)(12)(B)(i)(I), as described in paragraph (c)(2) of this section, or under an enhanced matching formula of section 401(k)(12)(B)(i)(II), as described in paragraph (c)(3) of this section.

(2) *Basic matching formula*. Under the basic matching formula, each eligible NHCE receives qualified matching contributions in an amount equal to the sum of—

(i) 100% of the amount of the employee's elective contributions that do not exceed 3% of the employee's safe harbor compensation; and

(ii) 50% of the amount of the employee's elective contributions that exceed 3% of the employee's safe harbor compensation but that do not exceed 5% of the employee's safe harbor compensation.

(3) *Enhanced matching formula*. Under an enhanced matching formula, each eligible NHCE receives a matching contribution under a formula that, at any rate of elective contributions by the employee, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been provided under the basic matching formula of paragraph (c)(2) of this section. In addition, under an enhanced matching formula, the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective contributions may not increase as the amount of an employee's elective contributions increases.

(4) *Limitation on HCE matching contributions*. The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if the ratio of matching contributions made on account of an HCE's elective contributions under the cash or deferred arrangement for a plan year to those elective contributions is greater than the ratio of matching contributions to elective contributions that would apply with respect to any eligible NHCE with elective contributions at the same percentage of safe harbor compensation.

(5) *Use of safe harbor match not precluded by certain plan provisions*—(i) *Safe harbor matching contributions on employee contributions*. The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions are made with respect to the sum of elective contributions and employee contributions on the same terms as safe harbor matching contributions are made with respect to elective contributions. Alternatively, the safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because safe harbor matching contributions are made on both elective contributions and employee contributions if safe harbor matching contributions on elective contributions are not affected by the amount of employee contributions.

(ii) *Periodic matching contributions*. The safe harbor matching contribution requirement of this paragraph (c) will not fail to be satisfied merely because the plan provides that safe harbor matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that safe harbor matching contributions with respect to any elective contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(6) *Permissible restrictions on elective contributions by NHCEs*—(i) *General rule*. The safe harbor matching contribution requirement of this paragraph (c) is not satisfied if elective contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (c)(6).

(ii) *Restrictions on election periods*. A plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (d) of this section) to make or change a cash or deferred election for the plan year. For purposes of this paragraph (c)(6)(ii), a 30-day period is deemed to be a reasonable period to make or change a cash or deferred election.

(iii) *Restrictions on amount of elective contributions*. A plan is permitted to limit the amount of elective contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (c)(6)(v) of this section) to make elective contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of elective contributions. However, a plan may require eligible employees to make cash or deferred elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred*. A plan may limit the types of compensation that may be deferred by an eligible employee under a plan, provided that each eligible NHCE is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2). Thus, the definition of compensation from which elective contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code*. A plan may limit the amount of elective contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make elective contributions has been suspended for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E).

(7) *Examples*. The following examples illustrate the safe harbor contribution requirement of this paragraph (c):

Example 1. (i) Beginning January 1, 2006, Employer A maintains Plan L covering employees (including HCEs and NHCEs) in Divisions D and E. Plan L contains a cash or deferred arrangement and provides qualified matching contributions equal to 100% of each eligible employee's elective contributions up to 3% of compensation and 50% of the next 2% of compensation. For purposes of the matching contribution formula, safe harbor compensation is defined as all compensation within the meaning of section 415(c)(3) (a definition that satisfies section 414(s)). Also, each employee is permitted to make elective contributions from all safe harbor compensation within the meaning of section 415(c)(3) and may change a cash or deferred election at any time. Plan L limits the amount of an employee's elective contributions for purposes of section 402(g) and section 415, and, in the case of a hardship distribution, suspends an employee's ability to make elective contributions for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E). All contributions under Plan L are nonforfeitable and are subject to the withdrawal restrictions of section 401(k)(2)(B). Plan L provides for no other contributions and Employer A maintains no other plans. Plan L is maintained on a calendar-year basis and all contributions for a plan year are made within 12 months after the end of the plan year.

(ii) Based on these facts, matching contributions under Plan L are safe harbor matching contributions because they are qualified matching contributions equal to the basic matching formula. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 2. (i) The facts are the same as in *Example 1*, except that instead of providing a basic matching contribution, Plan L provides a qualified matching contribution equal to 100% of each eligible employee's elective contributions up to 4% of safe harbor compensation.

(ii) Plan L's formula is an enhanced matching formula because each eligible NHCE receives safe harbor matching contributions at a rate that, at any rate of elective contributions, provides an aggregate amount of qualified matching contributions at least equal to the aggregate amount of qualified matching contributions that would have been received under the basic safe harbor matching formula, and the rate of matching contributions does not increase as the rate of an employee's elective contributions increases. Accordingly, Plan L satisfies the safe harbor contribution requirement of this paragraph (c).

Example 3. (i) The facts are the same as in *Example 1*, except that instead of permitting each employee to make elective contributions from all compensation within the meaning of section 415(c)(3), each employee's elective contributions under Plan L are limited to 15% of the employee's "basic compensation." Basic compensation is defined under Plan L as compensation within the meaning of section 415(c)(3), but excluding overtime pay.

(ii) The definition of basic compensation under Plan L is a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2).

(iii) Plan L will not fail to satisfy the safe harbor contribution requirement of this paragraph (c) merely because Plan L limits the amount of elective contributions and the types of compensation that may be deferred by eligible employees, provided that each eligible NHCE may make elective contributions equal to at least 4% of the employee's safe harbor compensation.

Example 4. (i) The facts are the same as in *Example 1*, except that Plan L provides that only employees employed on the last day of the plan year will receive a safe harbor matching contribution.

(ii) Even if the plan that provides for employee contributions and matching contributions satisfies the minimum coverage requirements of section 410(b)(1) taking into account this last-day requirement, Plan L would not satisfy the safe harbor contribution requirement of this paragraph (c) because safe harbor matching contributions are not made on behalf of all eligible NHCEs who make elective contributions.

(iii) The result would be the same if, instead of providing safe harbor matching contributions under an enhanced formula, Plan L provides for a 3% safe harbor nonelective contribution that is restricted to eligible employees under the cash or deferred arrangement who are employed on the last day of the plan year.

Example 5. (i) The facts are the same as in *Example 1*, except that instead of providing qualified matching contributions under the basic matching formula to employees in both Divisions D and E, employees in Division E are provided qualified matching contributions under the basic matching formula, while safe harbor matching contributions continue to be provided to employees in Division D under the enhanced matching formula described in *Example 2*.

(ii) Even if Plan L satisfies §1.401(a)(4)–4 with respect to each rate of matching contributions available to employees under the plan, the plan would fail to satisfy the safe harbor contribution requirement of this paragraph (c) because the rate of matching contributions with respect to HCEs in Division D at a rate of elective contributions between 3% and 5% would be greater than that with respect to NHCEs in Division E at the same rate of elective contributions. For example, an HCE in Division D who would have a 4% rate of elective contributions would have a rate of matching contributions of 100% while an NHCE in Division E who would have the same rate of elective contributions would have a lower rate of matching contributions.

(d) *Notice requirement*—(1) *General rule*. The notice requirement of this paragraph (d) is satisfied for a plan year if each eligible employee is given written notice of the employee's rights and obligations under the plan and the notice satisfies the content requirement of paragraph (d)(2) of this section and the timing requirement of paragraph (d)(3) of this section.

(2) *Content requirement*—(i) *General rule*. The content requirement of this paragraph (d)(2) is satisfied if the notice is—

(A) Sufficiently accurate and comprehensive to inform the employee of the employee's rights and obligations under the plan; and

(B) Written in a manner calculated to be understood by the average employee eligible to participate in the plan.

(ii) *Minimum content requirement*. Subject to the requirements of paragraph (d)(2)(iii) of this section, a notice is not considered sufficiently accurate and comprehensive unless the notice accurately describes—

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

(B) Any other contributions under the plan or matching contributions to another plan on account of elective contributions or employee contributions under the plan (including the potential for discretionary matching contributions) and the conditions under which such contributions are made;

(C) The plan to which safe harbor contributions will be made (if different than the plan containing the cash or deferred arrangement);

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

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

(F) The periods available under the plan for making cash or deferred elections;

(G) Withdrawal and vesting provisions applicable to contributions under the plan; and

(H) Information that makes it easy to obtain additional information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses and, if applicable, electronic addresses, of individuals or offices from whom employees can obtain such plan information.

(iii) *References to SPD*. A plan will not fail to satisfy the content requirements of this paragraph (d)(2) merely because, in the case of information described in paragraph (d)(2)(ii)(B) of this section (relating to any other contributions under the plan), paragraph (d)(2)(ii)(C) of this section (relating to the plan to which safe harbor contributions will be made) or paragraph (d)(2)(ii)(D) of this section (relating to the type and amount of compensation that may be deferred under the plan), the notice cross-references the relevant portions of a summary plan description that provides the same information that would be provided in accordance with such paragraphs and that has been provided (or is concurrently provided) to employees.

(3) *Timing requirement*—(i) *General rule*. The timing requirement of this paragraph (d)(3) is satisfied if the notice is provided within a reasonable period before the beginning of the plan year (or, in the year an employee becomes eligible, within a reasonable period before the employee becomes eligible). The determination of whether a notice satisfies the timing requirement of this paragraph (d)(3) is based on all of the relevant facts and circumstances.

(ii) *Deemed satisfaction of timing requirement*. The timing requirement of this paragraph (d)(3) is deemed to be satisfied if at least 30 days (and no more than 90 days) before the beginning of each plan year, the notice is given to each eligible employee for the plan year. In the case of an employee who does not receive the notice within the period described in the previous sentence because the employee becomes eligible after the 90th day before the beginning of the plan year, the timing requirement is deemed to be satisfied if the notice is provided no more than 90 days before the employee becomes eligible (and no later than the date the employee becomes eligible). Thus, for example, the preceding sentence would apply in the case of any employee eligible for the first plan year under a newly established plan that provides for elective contributions, or would apply in the case of the first plan year in which an employee becomes eligible under an existing plan that provides for elective contributions.

(e) *Plan year requirement*—(1) *General rule*. Except as provided in this paragraph (e) or in paragraph (f) of this section, a plan will fail to satisfy the requirements of section 401(k)(12) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of the plan year and remain in effect for an entire 12-month plan year. Moreover, if, as described under paragraph (g)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions specifying that the safe harbor contributions will be made in the other plan and providing that the contributions will be QNECs or QMACs must also be adopted before the first day of that plan year.

(2) *Initial plan year*. A newly established plan (other than a successor plan within the meaning of §1.401(k)–2(c)(2)(iii)) will not be treated as violating the requirements of this paragraph (e) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a cash or deferred arrangement will not fail to satisfy the requirement of this paragraph (e) if it is added to an existing profit sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during that year provided that—

(i) The plan is not a successor plan; and

(ii) The cash or deferred arrangement is made effective no later than 3 months prior to the end of the plan year.

(3) *Change of plan year*. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section for the immediately following plan year.

(4) *Final plan year*. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (e)(1) of this section merely because the final plan year is less than 12 months, provided that—

(i) The plan would satisfy the requirements of paragraph (g) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship comparable to a substantial business hardship described in section 412(d).

(f) *Plan amendments adopting safe harbor nonelective contributions*—(1) *General rule*. Notwithstanding paragraph (e)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section using nonelective contributions under paragraph (b) of this section, but only if the plan provides the contingent and follow-up notices described in this section. A plan amendment made pursuant to this paragraph (f)(1) for a plan year may provide for the use of the safe harbor method described in this section solely for that plan year and a plan sponsor is not limited in the number of years for which it is permitted to adopt an amendment providing for the safe harbor method of this section using nonelective contributions under paragraph (b) of this section.

(2) *Contingent notice provided*. A plan satisfies the requirement to provide the contingent notice under this paragraph (f)(2) if it provides a notice that would satisfy the requirements of paragraph (d) of this section, except that, in lieu of setting forth the safe harbor contributions used under the plan as set forth in paragraph (d)(2)(ii)(A) of this section, the notice specifies that the plan may be amended during the plan year to include the safe harbor nonelective contribution and that, if the plan is amended, a follow-up notice will be provided.

(3) *Follow-up notice requirement*. A plan satisfies the requirement to provide a follow-up notice under this paragraph (f)(3) if, no later than 30 days before the last day of the plan year, each eligible employee is given a notice that states that the safe harbor nonelective contributions will be made for the plan year. This notice is permitted to be combined with a contingent notice provided under paragraph (f)(2) of this section for the next plan year.

(g) *Permissible reduction or suspension of safe harbor matching contributions* — (1) *General rule*. A plan that provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(k)(3) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective contributions (and, if applicable, employee contributions) provided that—

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (g)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (g)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ADP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(k)–2(a)(2)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (g)) with respect to amounts deferred through the effective date of the amendment.

(2) *Notice of suspension requirement*. The notice of suspension requirement of this paragraph (g)(2) is satisfied if each eligible employee is given a written notice that explains—

(i) The consequences of the amendment which reduces or suspends matching contributions on future elective contributions and, if applicable, employee contributions;

(ii) The procedures for changing their cash or deferred election and, if applicable, their employee contribution elections; and

(iii) The effective date of the amendment.

(h) *Additional rules*—(1) *Contributions taken into account*. A contribution is taken into account for purposes of this section for a plan year if and only if the contribution would be taken into account for such plan year under the rules of §1.401(k)–2(a) or 1.401(m)–2(a). Thus, for example, a safe harbor matching contribution must be made within 12 months of the end of the plan year. Similarly, an elective contribution that would be taken into account for a plan year under §1.401(k)–2(a)(4)(i)(B)(*2*) must be taken into account for such plan year for purposes of this section, even if the compensation would have been received after the close of the plan year.

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests*. A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4). Thus, these contributions are not subject to the limitations on qualified nonelective contributions under §1.401(k)–2(a)(6)(ii), but are subject to the rules generally applicable to nonelective contributions under section 401(a)(4). See §1.401(a)(4)–1(b)(2)(ii). However, pursuant to section 401(k)(12)(E)(ii), to the extent they are needed to satisfy the safe harbor contribution requirement of paragraph (b) of this section, safe harbor nonelective contributions may not be taken into account under any plan for purposes of section 401(l) (including the imputation of permitted disparity under §1.401(a)(4)–7).

(3) *Early participation rules*. Section 401(k)(3)(F) and §1.401(k)–2(a)(1)(iii)(A), which provide an alternative nondiscrimination rule for certain plans that provide for early participation, do not apply for purposes of section 401(k)(12) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan*. Safe harbor matching or nonelective contributions may be made to the plan that contains the cash or deferred arrangement or to another defined contribution plan that satisfies section 401(a) or 403(a). If safe harbor contributions are made to another defined contribution plan, the safe harbor plan must specify the plan to which the safe harbors are made and contribution requirement of paragraph (b) or (c) of this section must be satisfied in the other defined contribution plan in the same manner as if the contributions were made to the plan that contains the cash or deferred arrangement. Consequently, the plan to which the contributions are made must have the same plan year as the plan containing the cash and deferred arrangement and each employee eligible under the plan containing the cash or deferred arrangement must be eligible under the same conditions under the other defined contribution plan. The plan to which the safe harbor contributions are made need not be a plan that can be aggregated with the plan that contains the cash or deferred arrangement.

(5) *Contributions used only once*. Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

§1.401(k)–4 SIMPLE 401(k) plan requirements.

(a) *General rule*. A cash or deferred arrangement satisfies the SIMPLE 401(k) plan provision of section 401(k)(11) for a plan year if the arrangement satisfies the requirements of paragraphs (b) through (i) of this section for that year. A plan that contains a cash or deferred arrangement that satisfies this section is referred to as a SIMPLE 401(k) plan. Pursuant to section 401(k)(11), a SIMPLE 401(k) plan is treated as satisfying the ADP test of section 401(k)(3)(A)(ii) for that year.

(b) *Eligible employer*—(1) *General rule*. A SIMPLE 401(k) plan must be established by an eligible employer. Eligible employer for purposes of this section means, with respect to any plan year, an employer that had no more than 100 employees who received at least $5,000 of SIMPLE compensation, as defined in paragraph (e)(5) of this section, from the employer for the prior calendar year.

(2) *Special rule*. An eligible employer that establishes a SIMPLE 401(k) plan for a plan year and that fails to be an eligible employer for any subsequent plan year, is treated as an eligible employer for the 2 plan years following the last plan year the employer was an eligible employer. If the failure is due to any acquisition, disposition, or similar transaction involving an eligible employer, the preceding sentence applies only if the provisions of section 410(b)(6)(C)(i) are satisfied.

(c) *Exclusive plan*—(1) *General rule*. The SIMPLE 401(k) plan must be the exclusive plan for each SIMPLE 401(k) plan participant for the plan year. This requirement is satisfied if there are no contributions made, or benefits accrued, for services during the plan year on behalf of any SIMPLE 401(k) plan participant under any other qualified plan maintained by the employer. Other qualified plan for purposes of this section means any plan, contract, pension, or trust described in section 219(g)(5)(A) or (B).

(2) *Special rule*. A SIMPLE 401(k) plan will not be treated as failing the requirements of this paragraph (c) merely because any SIMPLE 401(k) plan participant receives an allocation of forfeitures under another plan of the employer.

(d) *Election and notice*—(1) *General rule*. An eligible employer establishing or maintaining a SIMPLE 401(k) plan must satisfy the election and notice requirements in paragraphs (d)(2) and (d)(3) of this section.

(2) *Employee elections*—(i) *Initial plan year of participation*. For the plan year in which an employee first becomes eligible under the SIMPLE 401(k) plan, the employee must be permitted to make a cash or deferred election under the plan during a 60-day period that includes either the day the employee becomes eligible or the day before.

(ii) *Subsequent plan years*. For each subsequent plan year, each eligible employee must be permitted to make or modify his cash or deferred election during the 60-day period immediately preceding such plan year.

(iii) *Election to terminate*. An eligible employee must be permitted to terminate his cash or deferred election at any time. If an employee does terminate his cash or deferred election, the plan is permitted to provide that such employee cannot have elective contributions made under the plan for the remainder of the plan year.

(3) *Employee notices*. The employer must notify each eligible employee within a reasonable time prior to each 60-day election period, or on the day the election period starts, that he or she can make a cash or deferred election, or modify a prior election, if applicable, during that period. The notice must state whether the eligible employer will make the matching contributions described in paragraph (e)(3) of this section or the nonelective contributions described in paragraph (e)(4) of this section.

(e) *Contributions*—(1) *General rule*. A SIMPLE 401(k) plan satisfies the contribution requirements of this paragraph (e) for a plan year only if no contributions may be made to the SIMPLE 401(k) plan during such year, other than contributions described in this paragraph (e) and rollover contributions described in §1.402(c)–2, Q&A–1(a).

(2) *Elective contributions*. Subject to the limitations on annual additions under section 415, each eligible employee must be permitted to make an election to have up to $10,000 of elective contributions made on the employee's behalf under the SIMPLE 401(k) plan for a plan year. The $10,000 limit is increased beginning in 2006 in the same manner as the $160,000 amount is adjusted under section 415(d), except that pursuant to section 408(p)(2)(E)(ii) the base period shall be the calendar quarter beginning July 1, 2004, and any increase which is not a multiple of $500 is rounded to the next lower multiple of $500.

(3) *Matching contributions*. Each plan year, the eligible employer must contribute a matching contribution to the account of each eligible employee on whose behalf elective contributions were made for the plan year. The amount of the matching contribution must equal the lesser of the eligible employee's elective contributions for the plan year or 3% of the eligible employee's SIMPLE compensation for the entire plan year.

(4) *Nonelective contributions*. For any plan year, in lieu of contributing matching contributions described in paragraph (e)(3) of this section, an eligible employer may, in accordance with plan terms, contribute a nonelective contribution to the account of each eligible employee in an amount equal to 2% of the eligible employee's SIMPLE compensation for the entire plan year. The eligible employer may limit the nonelective contributions to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire plan year.

(5) *SIMPLE compensation*. Except as otherwise provided, the term SIMPLE compensation for purposes of this section means the sum of wages, tips, and other compensation from the eligible employer subject to federal income tax withholding (as described in section 6051(a)(3)) and the employee's elective contributions made under any other plan, and if applicable, elective deferrals under a section 408(p) SIMPLE IRA plan, a section 408(k)(6) SARSEP, or a plan or contract that satisfies the requirements of section 403(b), and compensation deferred under a section 457 plan, required to be reported by the employer on Form W–2 (as described in section 6051(a)(8)). For self-employed individuals, SIMPLE compensation means net earnings from self-employment determined under section 1402(a) prior to subtracting any contributions made under the SIMPLE 401(k) plan on behalf of the individual.

(f) *Vesting*. All benefits attributable to contributions described in paragraph (e) of this section must be nonforfeitable at all times.

(g) *Plan year*. The plan year of a SIMPLE 401(k) plan must be the whole calendar year. Thus, in general, a SIMPLE 401(k) plan can be established only on January 1 and can be terminated only on December 31. However, in the case of an employer that did not previously maintain a SIMPLE 401(k) plan, the establishment date can be as late as October 1 (or later in the case of an employer that comes into existence after October 1 and establishes the SIMPLE 401(k) plan as soon as administratively feasible after the employer comes into existence).

(h) *Other rules*. A SIMPLE 401(k) plan is not treated as a top-heavy plan under section 416. See section 416(g)(4)(G).

§1.401(k)–5 Special rules for mergers, acquisitions and similar events. [Reserved].

§1.401(k)–6 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(k) and the regulations thereunder.

Actual contribution percentage (ACP) test. *Actual contribution percentage test* or *ACP test* means the test described in §1.401(m)–2(a)(1).

Actual deferral percentage (ADP). *Actual deferral percentage* or *ADP* means the ADP of the group of eligible employees as defined in §1.401(k)–2(a)(2).

Actual deferral percentage (ADP) test. *Actual deferral percentage test* or *ADP test* means the test described in §1.401(k)–2(a)(1).

Actual deferral ratio (ADR). *Actual deferral ratio* or *ADR* means the ADR of an eligible employee as defined in §1.401(k)–2(a)(3).

Cash or deferred arrangement. *Cash or deferred arrangement* is defined in §1.401(k)–1(a)(2).

Cash or deferred election. *Cash or deferred election* is defined in §1.401(k)–1(a)(3).

Compensation. *Compensation* means compensation as defined in section 414(s) and §1.414(s)–1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. In the case of an HCE whose ADR is determined under §1.401(k)–2(a)(3)(ii), period of participation includes periods under another plan for which elective contributions are aggregated under §1.401(k)–2(a)(3)(ii). See also section 401(a)(17) and §1.401(a)(17)–1(c)(1).

Current year testing method. *Current year testing method* means the testing method described in §1.401(k)–2(a)(2)(ii) or §1.401(m)–2(a)(2)(ii) under which the applicable year is the current plan year.

Elective contributions. *Elective contributions* means employer contributions made to a plan pursuant to a cash or deferred election under a cash or deferred arrangement (whether or not the arrangement is a qualified cash or deferred arrangement under §1.401(k)–1(a)(4)).

Eligible employee—(1) *General rule*. *Eligible employee* means an employee who is directly or indirectly eligible to make a cash or deferred election under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (*e.g.*, formal application for participation or consent to payroll withholding) in order to be eligible to make a cash or deferred election for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs the acts.

(2) *Conditions on eligibility*. An employee who is unable to make a cash or deferred election because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (*e.g.*, satisfy a minimum period of service requirement) in order to be eligible to make a cash or deferred election for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. See §1.401(k)–1(e)(5), however, for certain limits on the use of minimum service requirements. An employee who would be eligible to make elective contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(k)(3) for a plan year even though the employee may not make a cash or deferred election by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) *Certain one-time elections*. An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible to make a cash or deferred election under any arrangement of the employer, is given the one-time opportunity to elect, and the employee does in fact elect, not to be eligible to make a cash or deferred election under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. This rule applies in addition to the rules in §1.401(k)–1(a)(3)(v) relating to the definition of a cash or deferred election. In no event is an election made after December 23, 1994, treated as a one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

Eligible HCE. *Eligible HCE* means an eligible employee who is an HCE.

Eligible NHCE. *Eligible NHCE* means an eligible employee who is not an HCE.

Employee. *Employee* means an employee within the meaning of §1.410(b)–9.

Employee stock ownership plan (ESOP). *Employee stock ownership plan* or *ESOP* means the portion of a plan that is an ESOP within the meaning of §1.410(b)–7(c)(2).

Employer. *Employer* means an employer within the meaning of §1.410(b)–9.

Excess contributions. *Excess contributions* means, with respect to a plan year, the amount of total excess contributions apportioned to an HCE under §1.401(k)–2(b)(2)(iii).

Excess deferrals. *Excess deferrals* means excess deferrals as defined in §1.402(g)–1(e)(3).

Highly compensated employee (HCE). *Highly compensated employee* or *HCE* has the meaning provided in section 414(q).

Matching contributions. *Matching contributions* means matching contributions as defined in §1.401(m)–1(a)(2).

Nonelective contributions. *Nonelective contributions* means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

Non-employee stock ownership plan (non-ESOP). *Non-employee stock ownership plan* or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)–7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or *NHCE* means an employee who is not an HCE.

Plan. Plan is defined in §1.401(k)–1(b)(4).

P*re-ERISA money purchase pension plan*. (1) *Pre-ERISA money purchase pension plan* is a pension plan—

(i) That is a defined contribution plan (as defined in section 414(i));

(ii) That was in existence on June 27, 1974, and as in effect on that date, included a salary reduction agreement; and

(iii) Under which neither the employee contributions nor the employer contributions, including elective contributions, may exceed the levels (as a percentage of compensation) provided for by the contribution formula in effect on June 27, 1974.

(2) A plan was in existence on June 27, 1974, if it was a written plan adopted on or before that date, even if no funds had yet been paid to the trust associated with the plan.

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(k)–2(a)(2)(ii) or §1.401(m)–2(a)(2)(ii).

Qualified matching contributions (QMACs). Qualified matching contributions or *QMACs* means matching contributions that, except as provided otherwise in §1.401(k)–1(c) and (d), satisfy the requirements of §1.401(k)–1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ACP test under §1.401(m)–2(a)(6). Thus, the matching contributions must satisfy the vesting requirements of §1.401(k)–1(c) and be subject to the distribution requirements of §1.401(k)–1(d) when they are contributed to the plan. See also §1.401(k)–2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

Qualified nonelective contributions (QNECs). Qualified nonelective contributions or *QNECs* means employer contributions, other than elective contributions or matching contributions, that, except as provided otherwise in §1.401(k)–1(c) and (d), satisfy the requirements of §1.401(k)–1(c) and (d) as though the contributions were elective contributions, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ACP test under §1.401(m)–2(a)(6). Thus, the nonelective contributions must satisfy the vesting requirements of §1.401(k)–1(c) and be subject to the distribution requirements of §1.401(k)–1(d) when they are contributed to the plan.

Rural cooperative plans. Rural cooperative plan means a plan described in section 401(k)(7).

Par. 3. Sections 1.401(m)–0 through 1.401(m)–2 are revised and sections 1.401(m)–3 through 1.401(m)–5 are added to read as follows:

§1.401(m)–0 Table of contents.

This section contains first a list of section headings and then a list of the paragraphs in each section in §§1.401(m)–1 through 1.401(m)–5.

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(iii) Exclusive means of correction.
(2) Correction through distribution.
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(B) Determination of the total amount of excess aggregate contributions.
(C) Satisfaction of ACP.
(iii) Apportionment of total amount of excess aggregate contributions among the HCEs.
(A) Calculate the dollar amount of excess aggregate contributions for each HCE.
(B) Limit on amount apportioned to any HCE.
(C) Apportionment to additional HCEs.
(iv) Income allocable to excess aggregate contributions.
(A) General rule.
(B) Method of allocating income.
(C) Alternative method of allocating income for the plan year.
(D) Safe harbor method of allocating gap period income.
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(F) Allocable income for recharacterized elective contributions.
(v) Distribution and forfeiture.
(vi) Tax treatment of corrective distributions.
(A) General rule.
(B) Rule for *de minimis* distributions.
(3) Other rules.
(i) No employee or spousal consent required.
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§1.401(m)–3 Safe harbor requirements.

(a) ACP test safe harbor.
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(e) Notice requirement.
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(1) General rule.
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(h) Permissible reduction or suspension of safe harbor matching contributions.
(1) General rule.
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(j) Other rules.
(1) Contributions taken into account.
(2) Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests.
(3) Early participation rules.
(4) Satisfying safe harbor contribution requirement under another defined contribution plan.
(5) Contributions used only once.
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§1.401(m)–4 Special rules for mergers, acquisitions and similar events. [Reserved].

§1.401(m)–5 Definitions.

§1.401(m)–1 Employee contributions and matching contributions.

(a) *General nondiscrimination rules*—(1) *Nondiscriminatory amount of contributions*—(i) *Exclusive means of* *amounts testing*. A defined contribution plan does not satisfy section 401(a) for a plan year unless the amount of employee contributions and matching contributions to the plan for the plan year satisfies section 401(a)(4). The amount of employee contributions and matching contributions under a plan satisfies the requirements of section 401(a)(4) with respect to amounts if and only if the amount of employee contributions and matching contributions satisfies the nondiscrimination test of section 401(m) under paragraph (b) of this section and the plan satisfies the additional requirements of paragraph (c) of this section. See §1.401(a)(4)–1(b)(2)(ii)(B).

(ii) *Testing benefits, rights and features*. A plan that provides for employee contributions or matching contributions must satisfy the requirements of section 401(a)(4) relating to benefits, rights and features in addition to the requirement regarding amounts described in paragraph (a)(1)(i) of this section. For example, the right to make each level of employee contributions and the right to each level of matching contributions under the plan are benefits, rights or features subject to the requirements of section 401(a)(4). See §1.401(a)(4)–4(e)(3)(i) and (iii)(F) through (G).

(2) *Matching contributions*—(i) *In general*. For purposes of section 401(m), this section and §§1.401(m)–2 through 1.401(m)–5, matching contributions are—

(A) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an employee contribution to a plan maintained by the employer;

(B) Any employer contribution (including a contribution made at the employer's discretion) to a defined contribution plan on account of an elective deferral; and

(C) Any forfeiture allocated on the basis of employee contributions, matching contributions, or elective deferrals.

(ii) *Employer contributions made on account of an employee contribution or elective deferral.* Whether an employer contribution is made on account of an employee contribution or an elective deferral is determined on the basis of all the relevant facts and circumstances, including the relationship between the employer contribution and employee actions outside the plan. An employer contribution made to a defined contribution plan on account of contributions made by an employee under an employer-sponsored savings arrangement that are not held in a plan that is intended to be a qualified plan or a plan described in §1.402(g)–1(b) is not a matching contribution.

(iii) *Employer contributions not on account of an employee contribution or elective deferral*. An employer contribution is not a matching contribution made on account of an elective deferral if it is contributed before the cash or deferred election is made or before the employee's performance of services with respect to which the elective deferral is made (or when the cash that is subject to the cash or deferred election would be currently available, if earlier). In addition, an employer contribution is not a matching contribution made on account of an employee contribution if it is contributed before the employee contribution.

(3) *Employee contributions*—(i) *In general*. For purposes of section 401(m), this section and §§1.401(m)–2 through 1.401(m)–5, employee contributions are contributions to a plan that are designated or treated at the time of contribution as after-tax employee contributions (*e.g.*, by treating the contributions as taxable income subject to applicable withholding requirements) and are allocated to an individual account for each eligible employee to which attributable earnings and losses are allocated. See §1.401(k)–1(a)(2)(ii). The term *employee contributions* includes—

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

(B) Employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan;

(C) Amounts attributable to excess contributions within the meaning of section 401(k)(8)(B) that are recharacterized as employee contributions under §1.401(k)–2(b)(3); and

(D) Employee contributions to a plan or contract that satisfies the requirements of section 403(b).

(ii) *Certain contributions not treated as employee contributions*. The term employee contributions does not include repayment of loans, repayment of distributions described in section 411(a)(7)(C), or employee contributions that are transferred to the plan from another plan.

(iii) *Qualified cost-of-living arrangements*. Employee contributions to a qualified cost-of-living arrangement described in section 415(k)(2)(B) are treated as employee contributions to a defined contribution plan, without regard to the requirement that the employee contributions be allocated to an individual account to which attributable earnings and losses are allocated.

(b) *Nondiscrimination requirements for amount of contributions*—(1) *Matching contributions and employee contributions*. The matching contributions and employee contributions under a plan satisfy this paragraph (b) for a plan year only if the plan satisfies—

(i)The ACP test of section 401(m)(2) described in §1.401(m)–2;

(ii) The ACP safe harbor provisions of section 401(m)(11) described in §1.401(m)–3; or

(iii) The SIMPLE 401(k) provisions of sections 401(k)(11) and 401(m)(10) described in §1.401(k)–4.

(2) *Automatic satisfaction by certain plans*. Notwithstanding paragraph (b)(1) of this section, the requirements of this section are treated as satisfied with respect to employee contributions and matching contributions under a collectively bargained plan (or the portion of a plan) that automatically satisfies section 410(b). See §§1.401(a)(4)–1(c)(5) and 1.410(b)–2(b)(7). Additionally, the requirements of sections 401(a)(4) and 410(b) do not apply to a governmental plan (within the meaning of section 414(d)) maintained by a state or local government or political subdivision thereof (or agency or instrumentality thereof). See sections 401(a)(5)(G), 403(b)(12)(C) and 410(c)(1)(A).

(3) *Anti-abuse provisions*. Sections 1.401(m)–1 through 1.401(m)–5 are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ACP for NHCEs (which is used as a benchmark for testing the ACP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of this

paragraph (b). Further, this paragraph (b) is part of the overall requirement that benefits or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of this paragraph (b) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ACP so as to increase significantly the permitted ACP for HCEs, or otherwise manipulate the nondiscrimination rules of this paragraph, if a principal purpose of the changes was to achieve such a result.

(4) *Aggregation and restructuring*—(i) *In general*. This paragraph (b)(4) contains the exclusive rules for aggregating and disaggregating plans that provide for employee contributions and matching contributions for purposes of this section and §§1.401(m)–2 through 1.401(m)–5.

(ii) *Aggregation of employee contributions and matching contributions within a plan*. Except as otherwise specifically provided in this paragraph (b)(4) and §1.401(m)–3(f)(1), a plan must be subject to a single test under paragraph (b)(1) of this section with respect to all employee contributions and matching contributions and all eligible employees under the plan. Thus, for example, if two groups of employees are eligible for matching contributions under a plan, all employee contributions and matching contributions under the plan must be subject to a single test, even if they have significantly different features, such as different rates of match.

(iii) *Aggregation of plans*—(A) *In general*. The term *plan* means a plan within the meaning of §1.410(b)–7(a) and (b), after application of the mandatory disaggregation rules of §1.410(b)–7(c), and the permissive aggregation rules of §1.410(b)–7(d), as modified by paragraph (b)(4)(v) of this section. Thus, for example, two plans (within the meaning of §1.410(b)–7(b)) that are treated as a single plan pursuant to the permissive aggregation rules of §1.410(b)–7(d) are treated as a single plan for purposes of sections 401(k) and 401(m).

(B) *Arrangements with inconsistent ACP testing methods*. Pursuant to paragraph (b)(4)(ii) of this section, a single testing method must apply with respect to all employee contributions and matching contributions and all eligible employees under a plan. Thus, in applying the permissive aggregation rules of §1.410(b)–7(d), an employer may not aggregate plans (within the meaning of §1.410(b)–7(b)) that apply inconsistent testing methods. For example, a plan (within the meaning of §1.410(b)–7) that applies the current year testing method may not be aggregated with another plan that applies the prior year testing method. Similarly, an employer may not aggregate a plan (within the meaning of §1.410(b)–7) that is using the ACP safe harbor provisions of section 401(m)(11) and another plan that is using the ACP test of section 401(m)(2).

(iv) *Disaggregation of plans and separate testing*—(A) *In general*. If employee contributions or matching contributions are included in a plan (within the meaning of §1.410(b)–7(b)) that is mandatorily disaggregated under the rules of section 410(b) (as modified by this paragraph (b)(4)), the matching contributions and employee contributions under that plan must be disaggregated in a consistent manner. For example, in the case of an employer that is treated as operating qualified separate lines of business under section 414(r), if the eligible employees under a plan which provides for employee contributions or matching contributions are in more than one qualified separate line of business, only those employees within each qualified separate line of business may be taken into account in determining whether each disaggregated portion of the plan complies with the requirements of section 401(m), unless the employer is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan. Similarly, if a plan that provides for employee contributions or matching contributions under which employees are permitted to participate before they have completed the minimum age and service requirements of section 410(a)(1) applies section 410(b)(4)(B) for determining whether the plan complies with section 410(b)(1), then the plan must be treated as two separate plans, one comprising all eligible employees who have met the minimum age and service requirements of section 410(a)(1) and one comprising all eligible employees who have not met the minimum age and service requirements of section 410(a)(1), unless the plan is using the rule in §1.401(m)–2(a)(1)(iii)(A).

(B) *Restructuring prohibited*. Restructuring under §1.401(a)(4)–9(c) may not be used to demonstrate compliance with the requirements of section 401(m). See §1.401(a)(4)–9(c)(3)(ii).

(v) *Certain disaggregation rules not applicable*. The mandatory disaggregation rules relating to section 401(k) plans and section 401(m) plans set forth in §1.410(b)–7(c)(1) and to ESOP and non-ESOP portions of a plan set forth in §1.410(b)–7(c)(2) shall not apply for purposes of this section and §§1.401(m)–2 through 1.401(m)–5. Accordingly, notwithstanding §1.410(b)–7(d)(2), an ESOP and a non-ESOP which are different plans (within the meaning of §1.410(b)–7(b)) are permitted to be aggregated for these purposes.

(c) *Additional requirements*—(1) *Separate testing for employee contributions and matching contributions*. Under §1.410(b)–7(c)(1), the group of employees who are eligible to make employee contributions or eligible to receive matching contributions must satisfy the requirements of section 410(b) as if those employees were covered under a separate plan. The determination of whether the separate plan satisfies the requirements of section 410(b) must be made without regard to the modifications to the disaggregation rules set forth in paragraph (b)(4)(v) of this section. In addition, except as expressly permitted under section 401(k), 410(b)(2)(A)(ii), or 416(c)(2)(A), employee contributions, matching contributions and elective contributions taken into account under §1.401(m)–2(a)(6) may not be taken into account for purposes of determining whether any other contributions under any plan (including the plan to which the employee contributions or matching contributions are made) satisfy the requirements of section 401(a). See also §1.401(a)(4)–11(g)(3)(vii) for special rules relating to corrections of violations of the minimum coverage requirements or discriminatory rates of matching contributions.

(2) *Plan provision requirement*. A plan that provides for employee contributions or matching contributions satisfies this section only if it provides that the nondiscrimination requirements of section 401(m) will be met. Thus, the plan must provide for satisfaction of one of the specific alternatives described in paragraph

(b)(1) of this section and, if with respect to that alternative there are optional choices, which of the optional choices will apply. For example, a plan that uses the ACP test of section 401(m)(2), as described in paragraph (b)(1)(i) of this section, must specify whether it is using the current year testing method or prior year testing method. Additionally, a plan that uses the prior year testing method must specify whether the ACP for eligible NHCEs for the first plan year is 3% or the ACP for the eligible NHCEs for the first plan year. Similarly, a plan that uses the safe harbor method of section 401(m)(11), as described in paragraph (b)(1)(ii) of this section, must specify whether the safe harbor contribution will be the nonelective safe harbor contribution or the matching safe harbor contribution and is not permitted to provide that ACP testing will be used if the requirements for the safe harbor are not satisfied. For purposes of this paragraph (c)(2), a plan may incorporate by reference the provisions of section 401(m)(2) and §1.401(m)–2 if that is the nondiscrimination test being applied.

(d) *Effective date*. This section and §§1.401(m)–2 through 1.401(m)–5 apply to plan years that begin on or after the date that is 12 months after the issuance of these regulations in final form.

§1.401(m)–2 ACP test.

(a) *Actual contribution percentage (ACP) test*—(1) *In general*—(i) *ACP test formula*. A plan satisfies the ACP test for a plan year only if—

(A) The ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 1.25; or

(B) The excess of the ACP for the eligible HCEs for the plan year over the ACP for the eligible NHCEs for the applicable year is not more than 2 percentage points, and the ACP for the eligible HCEs for the plan year is not more than the ACP for the eligible NHCEs for the applicable year multiplied by 2.

(ii) *HCEs as sole eligible employees*. If, for the applicable year there are no eligible NHCEs (*i.e.*, all of the eligible employees under the plan for the applicable year are HCEs), the plan is deemed to satisfy the ACP test.

(iii) *Special rule for early participation*. If a plan providing for employee contributions or matching contributions provides that employees are eligible to participate before they have completed the minimum age and service requirements of section 410(a)(1)(A), and if the plan applies section 410(b)(4)(B) in determining whether the plan meets the requirements of section 410(b)(1), then in determining whether the plan meets the requirements under paragraph (a)(1) of this section either—

(A) Pursuant to section 401(m)(5)(C), the ACP test is performed under the plan (determined without regard to disaggregation under §1.410(b)–7(c)(3)), using the ACP for all eligible HCEs for the plan year and the ACP of eligible NHCEs for the applicable year, disregarding all NHCEs who have not met the minimum age and service requirements of section 410(a)(1)(A); or

(B) Pursuant to §1.401(m)–1(b)(4), the plan is disaggregated into separate plans and the ACP test is performed separately for all eligible employees who have completed the minimum age and service requirements of section 410(a)(1)(A) and for all eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A).

(2) *Determination of ACP*—(i) *General rule*. The ACP for a group of eligible employees (either eligible HCEs or eligible NHCEs) for a plan year or applicable year is the average of the ACRs of eligible employees in the group for that year. The ACP for a group of eligible employees is calculated to the nearest hundredth of a percentage point.

(ii) *Determination of applicable year under current year and prior year testing method*. The ACP test is applied using the prior year testing method or the current year testing method. Under the prior year testing method, the applicable year for determining the ACP for the eligible NHCEs is the plan year immediately preceding the plan year for which the ACP test is being calculated. Under the prior year testing method, the ACP for the eligible NHCEs is determined using the ACRs for the eligible employees who were NHCEs in that preceding plan year, regardless of whether those NHCEs are eligible employees or NHCEs in the plan year for which the ACP test is being performed. Under the current year testing method, the applicable year for determining the ACP for eligible NHCEs is the same plan year as the plan year for which the ACP test is being calculated. Under either method, the ACP for the eligible HCEs is determined using the ACRs of eligible employees who are HCEs for the plan year for which the ACP test is being performed. See paragraph (c) of this section for additional rules for the prior year testing method.

(3) *Determination of ACR*—(i) *General rule*. The ACR of an eligible employee for the plan year or applicable year is the sum of the employee contributions and matching contributions taken into account with respect to such employee (determined under the rules of paragraphs (a)(4) and (a)(5) of this section), and the qualified nonelective and elective contributions taken into account under paragraph (a)(6) of this section for the year, divided by the employee's compensation taken into account for the year. The ACR is calculated to the nearest hundredth of a percentage point. If no employee contributions, matching contributions, elective contributions, or qualified nonelective contributions are taken into account under this section with respect to an eligible employee for the year, the ACR of the employee is zero.

(ii) *ACR of HCEs eligible under more than one plan*—(A) *General rule*. Pursuant to section 401(m)(2)(B), the ACR of an HCE who is an eligible employee in more than one plan of an employer to which matching contributions or employee contributions are made is calculated by treating all contributions with respect to such HCE under any such plan as being made under the plan being tested. Thus, the ACR for such an HCE is calculated by accumulating all matching contributions and employee contributions under any plan (other than a plan described in paragraph (a)(3)(ii)(B) of this section) that would be taken into account under this section for the plan year, if the plan under which the contribution was made applied this section and had the same plan year. For example, in the case of a plan with a 12-month plan year, the ACR for the plan year of that plan for an HCE who participates in multiple plans of the same employer that provide for matching contributions or employee contributions is the sum of all such contributions during such 12-month period that would be taken into account with respect to the HCE under all plans in which the HCE is an eligible employee, divided by the HCE's compensation for that 12-month period (determined using the compensation definition for the plan being tested), without regard to the plan year of the other plans and whether those plans are satisfying this section or §1.401(m)–3.

(B) *Plans not permitted to be aggregated.* Contributions under plans that are not permitted to be aggregated under §1.401(m)–1(b)(4) (determined without regard to the prohibition on aggregating plans with inconsistent testing methods set forth in §1.401(m)–1(b)(4)(iii)(B) and the prohibition on aggregating plans with different plan years set forth in §1.410(b)–7(d)(5)) are not aggregated under this paragraph (a)(3)(ii).

(iii) *Example.* The following example illustrates the application of paragraph (a)(3)(ii) of this section. See also §1.401(k)–2(a)(3)(iii) for additional examples of the application of the parallel rule under section 401(k)(3)(A). The example is as follows:

Example. Employee A, an HCE with compensation of $120,000, is eligible to make employee contributions under Plan S and Plan T, two calendar-year profit-sharing plans of Employer H. Plan S and Plan T use the same definition of compensation. Plan S provides a match equal to 50% of each employee's contributions and Plan T has no match. During the current plan year, Employee A elects to contribute $4,000 in employee contributions to Plan T and $4,000 in employee contributions to Plan S. There are no other contributions made on behalf of Employee A. Each plan must calculate Employee A's ACR by dividing the total employee contributions by Employee A and matching contributions under both plans by $120,000. Therefore, Employee A's ACR under each plan is 8.33% ($4,000+ $4,000+ $2,000/$120,000).

(4) *Employee contributions and matching contributions taken into account under the ACP test*—(i) *Employee contributions.* An employee contribution is taken into account in determining the ACR for an eligible employee for the plan year or applicable year in which the contribution is made. For purposes of the preceding sentence, an amount withheld from an employee's pay (or a payment by the employee to an agent of the plan) is treated as contributed at the time of such withholding (or payment) if the funds paid are transmitted to the trust within a reasonable period after the withholding (or payment).

(ii) *Recharacterized elective contributions.* Excess contributions recharacterized in accordance with §1.401(k)–2(b)(3) are taken into account as employee contributions for the plan year that includes the time at which the excess contribution is includible in the gross income of the employee under §1.401(k)–2(b)(3)(ii)(A).

(iii) *Matching contributions.* A matching contribution is taken into account in determining the ACR for an eligible employee for a plan year or applicable year only if each of the following requirements is satisfied—

(A) The matching contribution is allocated to the employee's account under the terms of the plan as of a date within that year;

(B) The matching contribution is made on account of (or the matching contribution is allocated on the basis of) the employee's elective deferrals or employee contributions for that year; and

(C) The matching contribution is actually paid to the trust no later than the end of the 12-month period immediately following the year that contains that date.

(5) *Matching contributions not taken into account under the ACP test*—(i) *General rule.* Matching contributions that do not satisfy the requirements of paragraph (a)(4)(iii) of this section may not be taken into account in the ACP test for the plan year with respect to which the contributions were made, or for any other plan year. Instead, the amount of the matching contributions must satisfy the requirements of section 401(a)(4) (without regard to the ACP test) for the plan year for which they are allocated under the plan as if they were nonelective contributions and were the only nonelective contributions for that year. See §§1.401(a)(4)–1(b)(2)(ii)(B) and 1.410(b)–7(c)(1).

(ii) *Disproportionate matching contributions*—(A) *Matching contributions in excess of 100%.* A matching contribution with respect to any employee contribution or elective deferral for an NHCE is not taken into account under the ACP test to the extent the matching rate with respect to the employee contribution or elective deferral exceeds the greater of 100% and 2 times the plan's representative matching rate.

(B) *Representative matching rate.* For purposes of this paragraph (a)(5)(ii), the plan's representative matching rate is the lowest matching rate for any eligible NHCE among a group of NHCEs that consists of half of all eligible NHCEs in the plan for the plan year who make elective deferrals or employee contributions for the plan year (or, if greater, the lowest matching rate for all eligible NHCEs in the plan who are employed by the employer on the last day of the plan year and who make elective deferrals or employee contributions for the plan year).

(C) *Definition of matching rate.* For purposes of this paragraph (a)(5)(ii), the matching rate for an employee is the matching contributions made for such employee divided by the elective deferrals or employee contributions that are being matched.

(iii) *Qualified matching contributions used to satisfy the ADP test.* Qualified matching contributions that are taken into account for the ADP test of section 401(k)(3) under §1.401(k)–2(a)(6) are not taken into account in determining an eligible employee's ACR.

(iv) *Matching contributions taken into account under safe harbor provisions.* A plan that satisfies the ACP safe harbor requirements of section 401(m)(11) for a plan year but nonetheless must satisfy the requirements of this section because it provides for employee contributions for such plan year is permitted to apply this section disregarding all matching contributions with respect to all eligible employees. In addition, a plan that satisfies the ADP safe harbor requirements of §1.401(k)–3 for a plan year using qualified matching contributions but does not satisfy the ACP safe harbor requirements of section 401(m)(11) for such plan year is permitted to apply this section by excluding matching contributions with respect to all eligible employees that do not exceed 4% of each employee's compensation. If a plan disregards matching contributions pursuant to this paragraph (a)(5)(iv), the disregard must apply with respect to all eligible employees.

(v) *Treatment of forfeited matching contributions.* A matching contribution that is forfeited because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution is not taken into account for purposes of this section.

(6) *Qualified nonelective contributions and elective contributions that may be taken into account under the ACP test.* Qualified nonelective contributions and elective contributions may be taken into

account in determining the ACR for an eligible employee for a plan year or applicable year, but only to the extent the contributions satisfy the following requirements—

(i) *Timing of allocation*. The qualified nonelective contribution is allocated to the employee's account as of a date within that year (within the meaning of §1.401(k)–2(a)(4)(i)(A)) and the elective contribution satisfies §1.401(k)–2(a)(4)(i). Consequently, under the prior year testing method, in order to be taken into account in calculating the ACP for the group of eligible NHCEs for the applicable year, a qualified nonelective contribution must be contributed no later than the end of the 12-month period following the applicable year even though the applicable year is different than the plan year being tested.

(ii) *Elective contributions taken into account under the ACP test*. Elective contributions may be taken into account for the ACP test only if the cash or deferred arrangement under which the elective contributions are made is required to satisfy the ADP test in §1.401(k)–2(a)(1) and, then only to the extent that the cash or deferred arrangement would satisfy that test, including such elective contributions in the ADP for the plan year or applicable year. Thus, for example, elective deferrals made pursuant to a salary reduction agreement under an annuity described in section 403(b) are not permitted to be taken into account in an ACP test. Similarly, elective contributions under a cash or deferred arrangement that is using the section 401(k) safe harbor described in §1.401(k)–3 can not be taken into account in an ACP test.

(iii) *Requirement that amount satisfy section 401(a)(4)*. The amount of nonelective contributions, including those qualified nonelective contributions taken into account under this paragraph (a)(6) and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)–2(a)(6), and the amount of nonelective contributions, excluding those qualified nonelective contributions taken into account under this paragraph (a)(6) for the ACP test and those qualified nonelective contributions taken into account for the ADP test under paragraph §1.401(k)–2(a)(6), satisfies the requirements of section 401(a)(4). See §1.401(a)(4)–1(b)(2). In the case of an employer that is applying the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan, the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) must be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on an employer-wide basis. Conversely, in the case of an employer that is treated as operating qualified separate lines of business, and does not apply the special rule for employer-wide plans in §1.414(r)–1(c)(2)(ii) with respect to the plan, then the determination of whether the qualified nonelective contributions satisfy the requirements of this paragraph (a)(6)(iii) is not permitted to be made on an employer-wide basis regardless of whether the plans to which the qualified nonelective contributions are made are satisfying the requirements of section 410(b) on that basis.

(iv) *Aggregation must be permitted*. The plan that provides for employee or matching contributions and the plan or plans to which the qualified nonelective contributions or elective contributions are made are plans that would be permitted to be aggregated under §1.401(m)–1(b)(4). If the plan year of the plan that provides for employee or matching contributions is changed to satisfy the requirement under §1.410(b)–7(d)(5) that aggregated plans have the same plan year, qualified nonelective contributions and elective contributions may be taken into account in the resulting short plan year only if such qualified nonelective and elective contributions could have been taken into account under an ADP test for a plan with that same short plan year.

(v) *Disproportionate contributions not taken into account*—(A) *General rule*. Qualified nonelective contributions cannot be taken into account for an applicable year for an NHCE to the extent such contributions exceed the product that NHCE's compensation and the greater of 5% and 2 times the plan's representative contribution rate. Any qualified nonelective contribution taken into account in an ADP test under §1.401(k)–2(a)(6) (including the determination of the representative contribution rate for purposes of §1.401(k)–2(a)(6)(iv)(B)) is not permitted to be taken into account for purposes of this paragraph (a)(6) (including the determination of the representative contribution rate for purposes of paragraph (a)(6)(v)(B) of this section).

(B) *Definition of representative contribution rate*. For purposes of this paragraph (a)(6)(v), the plan's representative contribution rate is the lowest applicable contribution rate of any eligible NHCE among a group of eligible NHCEs that consists of half of all eligible NHCEs for the plan year (or, if greater, the lowest applicable contribution rate of any eligible NHCE in the group of all eligible NHCEs for the applicable year and who is employed by the employer on the last day of the applicable year).

(C) *Definition of applicable contribution rate*. For purposes of this paragraph (a)(6)(v), the applicable contribution rate for an eligible NHCE is the sum of the matching contributions taken into account under this section for the employee for the plan year and the qualified nonelective contributions made for that employee for the plan year, divided by that employee's compensation for the same period.

(vi) *Contribution only used once*. Qualified nonelective contributions can not be taken into account under this paragraph (a)(6) to the extent such contributions are taken into account for purposes of satisfying any other ACP test, any ADP test, or the requirements of §1.401(k)–3, 1.401(m)–3 or 1.401(k)–4. Thus, for example, qualified nonelective contributions that are made pursuant to §1.401(k)–3(b) cannot be taken into account under the ACP test. Similarly, if a plan switches from the current year testing method to the prior year testing method pursuant to §1.401(m)–2(c)(1), qualified nonelective contributions that are taken into account under the current year testing method for a plan year may not be taken into account under the prior year testing method for the next plan year.

(7) *Examples*. The following examples illustrate the application of this paragraph (a). See §1.401(k)–2(a)(6) for additional examples of the parallel rules under section 401(k)(3)(A). The examples are as follows:

Example 1. (i) Employer L maintains Plan U, a profit-sharing plan under which \$.50 matching contributions are made for each dollar of employee contributions. Plan U uses the current year testing method. The chart below shows the average employee contributions (as a percentage of compensation) and matching contributions (as a percentage of compensation) for Plan U's highly compensated employees and nonhighly compensated employees for the 2006 plan year:

	Employee Contributions	Matching Contributions	Actual Contribution Percentage
Highly compensated employees	4%	2%	6%
Nonhighly compensated employees	3%	1.5%	4.5%

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees, as shown in the following table.

(iii) Because the ACP for the HCEs (6.0%) exceeds 5.63% (4.5% x 1.25), Plan U does not satisfy the ACP test under paragraph (a)(1)(i)(A) of this section. However, because the ACP for the HCEs does not exceed the ACP for the NHCEs by more than 2 percentage points and the ACP for the HCEs does not exceed the ACP for the NHCEs multiplied by 2 (4.5% x 2 = 9%), the plan satisfies the ACP test under paragraph (a)(1)(i)(B) of this section.

Example 2. (i) Employees A through F are eligible employees in Plan V, a profit-sharing plan of Employer M that includes a cash or deferred arrangement and permits employee contributions. Under Plan V, a $.50 matching contribution is made for each dollar of elective contributions and employee contributions. Plan V uses the current year testing method and does not provide for elective contributions to be taken into account in determining an eligible employee's ACR. For the 2006 plan year, Employees A and B are HCEs and the remaining employees are NHCEs. The compensation, elective contributions, employee contributions, and matching contributions for the 2006 plan year are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions
A	$190,000	$15,000	$3,500	$9,250
B	100,000	$5,000	$10,000	$7,500
C	85,000	$12,000	$0	$6,000
D	70,000	$9,500	$0	$4,750
E	40,000	$10,000	$0	$5,000
F	10,000	$0	$0	$0

(ii) The matching rate for all NHCEs is 50% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Accordingly, they are taken into account in determining the ACR of eligible employees, as shown in the following table:

Employee	Compensation	Employee Contributions	Matching Contributions	ACR %
A	$190,000	$3,500	$9,250	6.71
B	100,000	$10,000	$7,500	17.50
C	85,000	$0	$6,000	7.06
D	70,000	$0	$4,750	6.79
E	40,000	$0	$5,000	12.50
F	10,000	$0	$0	0

(iii) The ACP for the HCEs is 12.11% ((6.71% + 17.50%)/2). The ACP for the NHCEs is 6.59% ((7.06% + 6.79% + 12.50% + 0.%)/4). Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(A) of this section because the ACP of highly compensated employees is more than 125% of the ACP of the nonhighly compensated employees (6.59% x 1.25 = 8.24%). In addition, Plan V fails to satisfy the ACP test under paragraph (a)(1)(i)(B) of this section because the ACP for the HCEs exceeds the ACP of the other employees by more than 2 percentage points (6.59% + 2% = 8.59%). Therefore, the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 3. (i) The facts are the same as *Example 2*, except that the plan provides that the nonhighly compensated employees' elective contributions may be used to meet the requirements of section 401(m) to the extent needed under that section.

(ii) Pursuant to paragraph (a)(6)(ii) of this section, the $10,000 of elective contributions for Employee E may be taken into account in determining the ACP rather than the ADP to the extent that the plan satisfies the requirements of §1.401(k)–2(a)(1) excluding from the ADP this $10,000. In this case, if the $10,000 were excluded from the ADP for the NHCEs, the ADP for the highly compensated employees is 6.45% (7.89% + 5.00%)/2 and the ADP for the nonhighly compensated employees would be

6.92% (14.12% + 13.57% + 0% +0%)/4) and the plan would satisfy the requirements of §1.401(k)–2(a)(1) excluding from the ADP the elective contributions for NHCEs that are taken into account under section 401(m).

(iii) After taking into account the $10,000 of elective contributions for Employee E in the ACP test, the ACP for the nonhighly compensated employees is 12.84% (7.06% + 6.79% + 37.50 % + 0%)/4. Therefore the plan satisfies the ACP test because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the nonhighly compensated employees.

Example 4. (i) The facts are the same as *Example 2*, except that Plan V provides for a higher than 50% match rate on the elective contributions and employee contributions for all NHCEs. The match rate is defined as the rate, rounded up to the next whole percent, necessary to allow the plan to satisfy the ACP test, but not in excess of 100%. In this case, an increase in the match rate from 50% to 74% will be sufficient to allow the plan to satisfy the ACP test. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions at a 74% match rate of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions
C	$85,000	$12,000	$0	$8,880
D	70,000	$9,500	$0	$7,030
E	40,000	$10,000	$0	$7,400
F	10,000	$0	$0	$0

(ii) The matching rate for all NHCEs is 74% and thus the matching contributions are not disproportionate under paragraph (a)(5)(ii) of this section. Therefore, the matching contributions may be taken into account in determining the ACP for the NHCEs.

(iii) The ACP for the NHCEs is 9.75% (10.45% + 10.04% + 18.50% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m).

Example 5. (i) The facts are the same as *Example 4*, except that: Employee E's elective contributions are $2,000 (rather than $10,000) and pursuant to paragraph (a)(6)(ii) of this section, the $2,000 of elective contributions for Employee E are taken into account in determining the ACP rather than the ADP. In addition, Plan V provides that the higher match rate is not limited to 100% and applies only for a specified group of nonhighly compensated employees. The only member of that group is Employee E. Under the plan provision, the higher match rate is a 400% match. Thus, for the 2006 plan year, the compensation, elective contributions, employee contributions, matching contributions of the eligible NHCEs (employees C through F) are shown in the following table:

Employee	Compensation	Elective Contributions	Employee Contributions	Matching Contributions
C	$85,000	$12,000	$0	$6,000
D	70,000	$9,500	$0	$4,750
E	40,000	$2,000	$0	$8,000
F	10,000	$0	$0	$0

(ii) If the entire matching contribution made on behalf of Employee E were taken into account under the ACP test, Plan V would satisfy the test, because the ACP for the NHCEs would be 9.71% (7.06% + 6.79% + 25.00% + 0%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times what the ACP for the NHCEs would be, the plan would satisfy the requirements of section 401(m).

(iii) Pursuant to paragraph (a)(5)(ii) of this section, however, matching contributions for an eligible NHCE that are based on a matching rate in excess of the greater of 100% and twice the plan's representative matching rate cannot be taken into account in applying the ACP test. The plan's representative matching rate is the lowest matching rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year who make elective contributions or employee contributions for the plan year. For Plan V, the group of NHCEs who make such contributions consists of Employees C, D and E. The matching rates for these three employees are 50%, 50% and 400% respectively. The lowest matching rate for a group of NHCEs that is at least 1/2 of all the NHCEs who make elective contributions or employee contributions (or 2 NHCEs) is 50%. Because 400% is more than twice the plan's representative matching rate, only the matching contributions made on behalf of Employee E that do not exceed 100% (or in this case $2,000) satisfy the requirements of paragraph (a)(5)(ii) of this section and may be taken into account under the ACP test. Accordingly, the ACP for the NHCEs is 5.96% (7.06% + 6.79% + 10% + 0%)/4 and the plan fails to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section unless the ACP failure is corrected under paragraph (b) of this section.

Example 6. (i) The facts are the same as *Example 2*, except that Plan V provides a QNEC equal to 13% of pay for Employee F that will be taken into account under the ACP test to the extent the contributions satisfy the requirements of paragraph (a)(6) of this section.

(ii) Pursuant to paragraph (a)(6)(v) of this section, a QNEC cannot be taken into account in determining an NHCE's ACR to the extent it exceeds the greater of 5% and the product of the employee's compensation and the plan's representative contribution rate. The plan's representative contribution rate is two times the lowest applicable contribution rate for any eligible employee in a group of NHCEs that is at least half of all eligible employees who are NHCEs in the plan for the plan year. For Plan V, the applicable contribution rates for Employees C, D, E and F are 7.06%, 6.79%, 12.5% and 13% respectively. The lowest applicable rate for a group of NHCEs that is at least 1/2 of all the NHCEs is 12.50% (the lowest applicable rate for the group of NHCEs that consists of Employees E and F).

(iii) Under paragraph (a)(6)(v)(B) of this section, the plan's representative contribution rate is 2 times 12.50% or 25.00%. Accordingly, the QNECs for Employee F can be taken into account under the ACP test only to the extent they do not exceed 25.00% of compensation. In this case, all of the QNECs for Employee F may be taken into account under the ACP test.

(iv) After taking into account the QNECs for Employee F, the ACP for the NHCEs is 9.84% (7.06% + 6.79% + 12.50% + 13%)/4. Because the ACP for the HCEs (12.11%) is less than 1.25 times the ACP for the NHCEs, the plan satisfies the requirements of section 401(m)(2) and paragraph (a)(1) of this section.

(b) *Correction of excess aggregate contributions*—(1) *Permissible correction methods*—(i) *In general*. A plan that provides for employee contributions or matching contributions does not fail to satisfy the requirements of section 401(m)(2) and paragraph (a)(1) of this section if the employer, in accordance with the terms of the plan, uses either of the following correction methods—

(A) *Additional contributions*. The employer makes additional contributions that are taken into account for the ACP test under this section that, in combination with the other contributions taken into account under this section, allow the plan to satisfy the requirements of paragraph (a)(1) of this section.

(B) *Excess aggregate contributions distributed or forfeited.* Excess aggregate contributions are distributed or forfeited in accordance with paragraph (b)(2) of this section.

(ii) *Combination of correction methods*. A plan may provide for the use of either of the correction methods described in paragraph (b)(1)(i) of this section, may limit employee contributions or matching contributions in a manner that prevents excess aggregate contributions from being made, or may use a combination of these methods, to avoid or correct excess aggregate contributions. If a plan uses a combination of correction methods, any contributions made under paragraph (b)(1)(i)(A) of this section must be taken into account before application of the correction method in paragraph (b)(1)(i)(B) of this section.

(iii) *Exclusive means of correction*. A failure to satisfy the requirements of paragraph (a)(1) of this section may not be corrected using any method other than one described in paragraph (b)(1)(i) or (ii) of this section. Thus, excess aggregate contributions for a plan year may not be corrected by forfeiting vested matching contributions, distributing nonvested matching contributions, recharacterizing matching contributions, or not making matching contributions required under the terms of the plan. Similarly, excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation to one or more employees in any future year. In addition, excess aggregate contributions may not be corrected using the retroactive correction rules of §1.401(a)(4)–11(g). See §1.401(a)(4)–11(g)(3)(vii) and (5).

(2) *Correction through distribution*—(i) *General rule*. This paragraph (b)(2) contains the rules for correction of excess aggregate contributions through a distribution from the plan. Correction through a distribution generally involves a four step process. First, the plan must determine, in accordance with paragraph (b)(2)(ii) of this section, the total amount of excess aggregate contributions that must be distributed under the plan. Second, the plan must apportion the total amount of excess aggregate contributions among the HCEs in accordance with paragraph (b)(2)(iii) of this section. Third, the plan must determine the income allocable to excess aggregate contributions in accordance with paragraph (b)(2)(iv) of this section. Finally, the plan must distribute the apportioned contributions, together with allocable income (or forfeit the apportioned matching contributions, if forfeitable) in accordance with paragraph (b)(2)(v) of this section. Paragraph (b)(2)(vi) of this section provides rules relating to the tax treatment of these distributions.

(ii) *Calculation of total amount to be distributed*. The following procedures must be used to determine the total amount of the excess aggregate contributions to be distributed—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE*. The amount of excess aggregate contributions attributable to an HCE for a plan year is the amount (if any) by which the HCE's contributions taken into account under this section must be reduced for the HCE's ACR to equal the highest permitted ACR under the plan. To calculate the highest permitted ACR under a plan, the ACR of the HCE with the highest ACR is reduced by the amount required to cause that HCE's ACR to equal the ACR of the HCE with the next highest ACR. If a lesser reduction would enable the plan to satisfy the requirements of paragraph (b)(2)(ii)(C) of this section, only this lesser reduction applies.

(B) *Determination of the total amount of excess aggregate contributions*. The process described in paragraph (b)(2)(ii)(A) of this section must be repeated until the plan would satisfy the requirements of paragraph (b)(2)(ii)(C) of this section. The sum of all reductions for all HCEs determined under paragraph (b)(2)(ii)(A) of this section is the total amount of excess aggregate contributions for the plan year.

(C) *Satisfaction of ACP*. A plan satisfies this paragraph (b)(2)(ii)(C) if the plan would satisfy the requirements of paragraph (a)(1)(i) of this section if the ACR for each HCE were determined after the reductions described in paragraph (b)(2)(ii)(A) of this section.

(iii) *Apportionment of total amount of excess aggregate contributions among the HCEs*. The following procedures must be used in apportioning the total amount of excess aggregate contributions determined under paragraph (b)(2)(ii) of this section among the HCEs—

(A) *Calculate the dollar amount of excess aggregate contributions for each HCE*. The contributions with respect to the HCE with the highest dollar amount of contributions taken account under this section are reduced by the amount required to cause that HCE's contributions to equal the dollar amount of contributions taken into account under this section for the HCE with the next highest dollar amount of such contributions. If a lesser apportionment to the HCE would enable the plan to apportion the total amount of excess aggregate contributions, only the lesser apportionment would apply.

(B) *Limit on amount apportioned to any HCE*. For purposes of this paragraph (b)(2)(iii), the contributions for an HCE who is an eligible employee in more than one plan of an employer to which matching contributions and employee contributions are made is determined by adding together all contributions otherwise taken into account in determining the ACR of the HCE under the rules of paragraph (a)(3)(ii) of this section. However, the amount of contributions apportioned with respect to an HCE must not exceed the amount of contributions taken into account under this section that were actually made on behalf of the HCE to the plan for the plan year. Thus, in the case of an HCE who is an eligible employee in more than one plan of the same employer to which employee contributions or matching contributions are made and whose ACR is calculated in accordance with paragraph (a)(3)(ii) of this section, the amount distributed under this paragraph (b)(2)(iii) will not exceed such contributions actually contributed to the plan for the plan year that are taken into account under this section for the plan year.

(C) *Apportionment to additional HCEs*. The procedure in paragraph (b)(2)(iii)(A) of this section must be repeated until the total amount of excess aggregate contributions have been apportioned.

(iv) *Income allocable to excess aggregate contributions*—(A) *General rule*. The income allocable to excess aggregate contributions is equal to the sum of the allocable gain or loss for the plan year and, to the extent the excess aggregate contributions are or will be credited with allocable gain or loss for the period after the close of the plan year (the gap period), the allocable gain or loss for the gap period.

(B) *Method of allocating income*. A plan may use any reasonable method for computing the income allocable to excess aggregate contributions, provided that the method does not violate section 401(a)(4), is used consistently for all participants and for all corrective distributions under the plan for the plan year, and is used by the plan for allocating income to participants' accounts. See §1.401(a)(4)–1(c)(8).

(C) *Alternative method of allocating income for the plan year*. A plan may allocate income to excess aggregate contributions for the plan year by multiplying the income for the plan year allocable to employee contributions, matching contributions and other amounts taken into account under this section (including the contributions for the year), by a fraction, the numerator of which is the excess aggregate contributions for the employee for the plan year, and the denominator of which is the account balance attributable to employee contributions and matching contributions and other amounts taken into account under this section as of the beginning of the plan year (including any additional such contributions for the plan year).

(D) *Safe harbor method of allocating gap period income*. A plan may use the safe harbor method in this paragraph (b)(2)(iv)(D) to determine income on excess aggregate contributions for the gap period. Under this safe harbor method, income on excess aggregate contributions for the gap period is equal to 10% of the income allocable to excess aggregate contributions for the plan year that would be determined under paragraph (b)(2)(iv)(C) of this section, multiplied by the number of calendar months that have elapsed since the end of the plan year. For purposes of calculating the number of calendar months that have elapsed under the safe harbor method, a corrective distribution that is made on or before the fifteenth day of a month is treated as made on the last day of the preceding month and a distribution made after the fifteenth day of a month is treated as made on the last day of the month.

(E) *Alternative method of allocating plan year and gap period income*. A plan may determine the allocable gain or loss for the aggregate of the plan year and the gap period by applying the alternative method provided by paragraph (b)(2)(iv)(C) of this section to that aggregate period. This is accomplished by substituting the income for the plan year and the gap period for the income for the plan year and by substituting the contributions taken into account under this section for the plan year and the gap period for the contributions taken into account for the plan year in determining the fraction that is multiplied by that income.

(F) *Allocable income for recharacterized elective contributions*. If recharacterized elective contributions are distributed as excess aggregate contributions, the income allocable to the excess aggregate contributions is determined as if recharacterized elective contributions had been distributed as excess contributions. Thus, income must be allocated to the recharacterized amounts distributed using the methods in §1.401(k)–2(b)(2)(iv).

(v) *Distribution and forfeiture*. Within 12 months after the close of the plan year in which the excess aggregate contribution arose, the plan must distribute to each HCE the contributions apportioned to such HCE under paragraph (b)(2)(iii) of this section (and the allocable income) to the extent they are vested or forfeit such amounts, if forfeitable. Except as otherwise provided in this paragraph (b)(2)(v), a distribution of excess aggregate contributions must be in addition to any other distributions made during the year and must be designated as a corrective distribution by the employer. In the event of a complete termination of the plan during the plan year in which an excess aggregate contribution arose, the corrective distribution must be made as soon as administratively feasible after the date of termination of the plan, but in no event later than 12 months after the date of termination. If the entire account balance of an HCE is distributed prior to when the plan makes a distribution of excess aggregate contributions in accordance with this paragraph (b)(2), the distribution is deemed to have been a corrective distribution of excess aggregate contributions (and income) to the extent that a corrective distribution would otherwise have been required.

(vi) *Tax treatment of corrective distributions*—(A) *General rule*. Except as otherwise provided in paragraph (b)(2)(vi)(B) of this section, a corrective distribution of excess aggregate contributions (and income) that is made within 2$^1/_2$ months after the end of the plan year for which the excess aggregate contributions were made is includible in the employee's gross income for the taxable year of the employee ending with or within the plan year for which the excess aggregate contributions were made. A corrective distribution of excess aggregate contributions (and income) that is made more than 2$^1/_2$ months after the plan year for which the excess aggregate contributions were made is includible in the employee's gross income in the taxable year of the employee in which distributed. The portion of the distribution that is treated as an investment in the contract under section 72 is determined without regard to any plan contributions other than those distributed as excess aggregate contributions. Regardless of when the corrective distribution is made, it is not subject to the early distribution tax of section 72(t). See paragraph (b)(4) of this section for additional rules relating to the employer excise tax on amounts distributed more than 2$^1/_2$ months after the end of the plan year. See also §1.402(c)–2, A–4 prohibiting rollover of distributions that are excess aggregate contributions.

(B) *Rule for de minimis distributions*. If the total amount of excess aggregate contributions determined under this paragraph (b)(2), and excess contributions determined under §1.401(k)–2(b)(2) distributed to a recipient under a plan for any plan year is less than $100 (excluding income), a corrective distribution of excess aggregate contributions (and income) is includible in gross income in the recipient's taxable year in which the corrective distribution is made.

(3) *Other rules*—(i) *No employee or spousal consent required*. A distribution of excess aggregate contributions (and income) may be made under the terms of the plan without regard to any notice or consent otherwise required under sections 411(a)(11) and 417.

(ii) *Treatment of corrective distributions and forfeited contributions as employer contributions*. Excess aggregate contributions (other than amounts attributable to employee contributions), including forfeited matching contributions, are treated as employer contributions for purposes of sections 404 and 415 even if distributed from the plan. Forfeited matching contributions that are reallocated to the accounts of other participants for the plan year in which the forfeiture occurs are treated under section 415 as annual additions for the participants to whose accounts they are reallocated and for the participants from whose accounts they are forfeited.

(iii) *No reduction of required minimum distribution*. A distribution of excess aggregate contributions (and income) is not treated as a distribution for purposes of determining whether the plan satisfies the minimum distribution requirements of section 401(a)(9). See §1.401(a)(9)–5, A–9(b).

(iv) *Partial correction*. Any distribution of less than the entire amount of excess aggregate contributions (and allocable income) is treated as a *pro rata* distribution of excess aggregate contributions and allocable income.

(v) *Matching contributions on excess contributions, excess deferrals and excess aggregate contributions*—(A) *Corrective distributions not permitted*. A matching contribution may not be distributed merely because the contribution to which it relates is treated as an excess contribution, excess deferral, or excess aggregate contribution.

(B) *Coordination with section 401(a)(4)*. A matching contribution is taken into account under section 401(a)(4) even if the match is distributed, unless the distributed contribution is an excess aggregate contribution. This requires that, after correction of excess aggregate contributions, each level of matching contributions be currently and effectively available to a group of employees that satisfies section 410(b). See §1.401(a)(4)–4(e)(3)(iii)(G). Thus, a plan that provides the same rate of matching contributions to all employees will not meet the requirements of section 401(a)(4) if employee contributions are distributed under this paragraph (b) to HCEs to the extent needed to meet the requirements of section 401(m)(2), while matching contributions attributable to employee contributions remain allocated to the HCEs' accounts. This is because the level of matching contributions will be higher for a group of employees that consists entirely of HCEs. Under section 411(a)(3)(G) and §1.411(a)–4(b)(7), a plan may forfeit matching contributions attributable to excess contributions, excess aggregate contributions and excess deferrals to avoid a violation of section 401(a)(4). See also §1.401(a)(4)–11(g)(3)(vii)(B) regarding the use of additional allocations to the accounts of NHCEs for the purpose of correcting a discriminatory rate of matching contributions. A plan is permitted to provide for which contributions are to be distributed to satisfy the ACP test so as to avoid discriminatory matching rates that would otherwise violate section 401(a)(4). For example, the plan may provide that unmatched employee contributions will be distributed before matched employee contributions.

(vi) *No requirement for recalculation*. If the distributions and forfeitures described in paragraph (b)(2) of this section are made, the employee contributions and matching contributions are treated as meeting the nondiscrimination test of section 401(m)(2) regardless of whether the ACP for the HCEs, if recalculated after the distributions and forfeitures, would satisfy section 401(m)(2).

(4) *Failure to timely correct*—(i) *Failure to correct within 2½ months after end of plan year*. If a plan does not correct excess aggregate contributions within 2½ months after the close of the plan year for which the excess aggregate contributions are made, the employer will be liable for a 10% excise tax on the amount of the excess aggregate contributions. See section 4979 and §54.4979–1 of this chapter. Qualified nonelective contributions properly taken into account under paragraph (a)(6) of this section for a plan year may enable a plan to avoid having excess aggregate contributions, even if the contributions are made after the close of the 2½ month period.

(ii) *Failure to correct within 12 months after end of plan year*. If excess aggregate contributions are not corrected within 12 months after the close of the plan year for which they were made, the plan will fail to meet the requirements of section 401(a)(4) for the plan year for which the excess aggregate contributions were made and all subsequent plan years in which the excess aggregate contributions remain in the trust.

(5) *Examples*. The following examples illustrate the application of this paragraph. See also §1.401(k)–2(b) for additional examples of the parallel correction rules applicable to cash or deferred arrangements. For purposes of these examples, none of the plans provide for catch-up contributions under section 414(v). The examples are as follows:

Example 1. (i) Employer L maintains a plan that provides for employee contributions and fully vested matching contributions. The plan provides that failures of the ACP test are corrected by distribution. In 2006, the ACP for the eligible NHCEs is 6%. Thus, the ACP for the eligible HCEs may not exceed 8%. The three HCEs who participate have the following compensation, contributions, and ACRs:

Employee	Compensation	Employee contributions and matching contributions	Actual Contribution Ratio
A	200,000	14,000	7%
B	150,000	13,500	9
C	100,000	12,000	12
			Average 9.33%

(ii) The total amount of excess aggregate contributions for the HCEs is determined under paragraph (b)(2)(ii) of this section as follows: the matching and employee contributions of Employee C (the HCE with the highest ACR) is reduced by 3% of compensation (or $3,000) in order to reduce the ACR of that HCE to 9%, which is the ACR of Employee B.

(iii) Because the ACP of the HCEs determined after the $3,000 reduction still exceeds 8%, further reductions in matching contributions and employee contributions are necessary in order to reduce the ACP of the HCEs to 8%. The employee contributions and matching contributions for Employees B and C are reduced by an additional .5% of compensation or $1,250 ($750 and $500 respectively). Because the ACP of the HCEs determined after the reductions now equals 8%, the plan would satisfy the requirements of (a)(1)(ii) of this section.

(iv) The total amount of excess aggregate contributions ($4,250) is apportioned among the HCEs under paragraph (b)(2)(iii) of this section first to the HCE with the highest amount of matching contributions and employee contributions. Therefore, Employee A is apportioned $500 (the amount required to cause A's matching contributions and employee contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(v) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($3,750) of the total amount of excess aggregate contributions is apportioned equally among Employees A and B ($1,500 to each, the amount required to cause their contributions to equal the next highest dollar amount of matching contributions and employee contributions).

(vi) Because the total amount of excess aggregate contributions has not been apportioned, further apportionment is necessary. The balance ($750) of the total amount of excess aggregate contributions is apportioned equally among Employees A, B and C ($250 to each, the amount required to allocate the total amount of excess aggregate contributions for the plan).

(vii) Therefore, the plan will satisfy the requirements of paragraph (a)(1) of this section if, by the end of the 12 month period following the end of the 2006 plan year, Employee A receives a corrective distribution of excess aggregate contributions equal to $2,250 ($500 + $1,500 + $250) and allocable income, Employee B receives a corrective distribution of $250 and allocable income and Employee C receives a corrective distribution of $1,750 ($1,500 + $250) and allocable income.

Example 2. (i) Employee D is the sole HCE who is eligible to participate in a cash or deferred arrangement maintained by Employer M. The plan that includes the arrangement, Plan X, permits employee contributions and provides a fully vested matching contribution equal to 50% of elective contributions. Plan X is a calendar year plan. Plan X corrects excess contributions by recharacterization and provides that failures of the ACP test are corrected by distribution. For the 2006 plan year, D's compensation is $200,000, and D's elective contributions are $15,000. The actual deferral percentages and actual contribution percentages for Employee D and the other eligible employees under Plan X are shown in the following table:

	Actual Deferral Percentage	Actual Contribution Percentage
Employee D	7.5%	3.75%
NHCEs	4%	2%

(ii) In February 2007, Employer M determines that D's actual deferral ratio must be reduced to 6%, or $12,000, which requires a recharacterization of $3,000 as an employee contribution. This increases D's actual contribution ratio to 5.25% ($7,500 in matching contributions plus $3,000 recharacterized as employee contributions, divided by $200,000 in compensation). Since D's actual contribution ratio must be limited to 4% for Plan X to satisfy the actual contribution percentage test, Plan X must distribute 1.25% or $2,500 of D's employee contributions and matching contributions together with allocable income. If $2,500 in matching contributions and allocable income is distributed, this will correct the excess aggregate contributions and will not result in a discriminatory rate of matching contributions. See *Example 8*.

Example 3. (i) The facts are the same as in *Example 2*, except that Employee D also had elective contributions under Plan Y, maintained by an employer unrelated to M. In January 2007, D requests and receives a distribution of $1,200 in excess deferrals from Plan X. Pursuant to the terms of Plan X, D forfeits the $600 match on the excess deferrals to correct a discriminatory rate of match.

(ii) The $3,000 that would otherwise have been recharacterized for Plan X to satisfy the actual deferral percentage test is reduced by the $1,200 already distributed as an excess deferral, leaving $1,800 to be recharacterized. See §1.401(k)–2(b)(4)(i)(A). D's actual contribution ratio is now 4.35% ($7,500 in matching contributions plus $1,800 in recharacterized contributions less $600 forfeited matching contributions attributable to the excess deferrals, divided by $200,000 in compensation).

(iii) The matching and employee contributions for Employee D must be reduced by .35% of compensation in order to reduce the ACP of the HCEs to 4%. The plan must provide for forfeiture of additional matching contributions to prevent a discriminatory rate of matching contributions. See *Example 8*.

Example 4. (i) The facts are the same as in *Example 3*, except that D does not request a distribution of excess deferrals until March 2007. Employer X has already recharacterized $3,000 as employee contributions.

(ii) Under §1.402(g)–1(e)(6), the amount of excess deferrals is reduced by the amount of excess contributions that are recharacterized. Because the amount recharacterized is greater than the excess deferrals, Plan X is neither required nor permitted to make a distribution of excess deferrals, and the recharacterization has corrected the excess deferrals.

Example 5. (i) For the 2006 plan year, Employee F defers $10,000 under Plan M and $6,000 under Plan N. Plans M and N, which have calendar plan years are maintained by unrelated employers. Plan M provides a fully vested, 100% matching contribution, does not take elective contributions into account under section 401(m) or take matching contributions into account under section 401(k) and provides that excess contributions and excess aggregate contributions are corrected by distribution. Under Plan M, Employee F is allocated excess contributions of $600 and excess aggregate contributions of $1,600. Employee F timely requests and receives a distribution of the $1,000 excess deferral from Plan M and, pursuant to the terms of Plan M, forfeits the corresponding $1,000 matching contribution.

(ii) No distribution is required or permitted to correct the excess contributions because $1,000 has been distributed by Plan M as excess deferrals. The distribution required to correct the excess aggregate contributions (after forfeiting the matching contribution) is $600 ($1,600 in excess aggregate contributions minus $1,000 in forfeited matching contributions). If Employee F had corrected the excess deferrals of $1,000 by withdrawing $1,000 from Plan N, Plan M would have had to correct the $600 excess contributions in Plan M by distributing $600. Since Employee F then would have forfeited $600 (instead of $1,000) in matching contributions, Employee F would have had $1,000 ($1,600 in excess aggregate contributions minus $600 in forfeited matching contributions) remaining of excess aggregate contributions in Plan M. These would have been corrected by distributing an additional $1,000 from Plan M.

Example 6. (i) Employee G is the sole highly compensated employee in a profit sharing plan under which the employer matches 100% of employee contributions up to 2% of compensation, and 50% of employee contributions up to the next 4% of compensation. For the 2008 plan year, Employee G has compensation of $100,000 and makes a 7% employee contribution of $7,000. Employee G receives a 4% matching contribution or $4,000. Thus, Employee G's actual contribution ratio (ACR) is 11%. The actual contribution percentage for the nonhighly compensated employees is 5%, and the employer determines that Employee G's ACR must be reduced to 7% to comply with the rules of section 401(m).

(ii) In this case, the plan satisfies the requirements of section if it distributes the unmatched employee contributions of $1,000, and $2,000 of matched employee contributions with their related matches of $1,000. This would leave Employee G with 4% employee contributions, and 3% matching contributions, for an ACR of 7%. Alternatively, the plan could distribute all matching contributions and satisfy this section. However, the plan could not distribute $4,000 of Employee G's employee contributions without forfeiting the related matching contributions because this would result in a discriminatory rate of matching contributions. See also *Example 7*.

Example 7. (i) Employee H is an HCE in Employer X's profit sharing plan, which matches 100% of employee contributions up to 5% of compensation. The matching contribution is vested at the rate of 20% per year. In 2006, Employee H makes $5,000 in employee contributions and receives $5,000 of matching contributions. Employee H is 60% vested in the matching contributions at the end of the 2006 plan year. In February 2007, Employer X determines that Employee H has excess aggregate contributions of $1,000. The plan provides that only matching contributions will be distributed as excess aggregate contributions.

(ii) Employer X has two options available in distributing Employee H's excess contributions. The first option is to distribute $600 of vested matching contributions and forfeit $400 of nonvested matching contributions. These amounts are in proportion to Employee H's vested and nonvested interests in all matching contributions. The second option is to distribute $1,000 of vested matching contributions, leaving the nonvested matching contributions in the plan.

(iii) If the second option is chosen, the plan must also provide a separate vesting schedule for vesting these nonvested matching contributions. This is necessary because the nonvested matching contributions must vest as rapidly as they would have had no distribution been made. Thus, 50% must vest in each of the next 2 years.

(iv) The plan will not satisfy the nondiscriminatory availability requirement of section 401(a)(4) if only nonvested matching contributions are distributed because the effect is that matching contributions for HCEs vest more rapidly than those for NHCEs. See §1.401(m)–1(e)(4).

Example 8. (i) Employer Y maintains a calendar year profit sharing plan that includes a cash or deferred arrangement. Elective contributions are matched at the rate of 100%. After-tax employee contributions are permitted under the plan only for nonhighly compensated employees and are matched at the same rate. No employees make excess deferrals. Employee J, a highly compensated employee, makes an $8,000 elective contribution and receives an $8,000 matching contribution.

(ii) Employer Y performs the actual deferral percentage (ADP) and the actual contribution percentage (ACP). To correct failures of the ADP and ACP tests, the plan distributes to A $1,000 of excess contributions and $500 of excess aggregate contributions. After the distributions, Employee J's contributions for the year are $7,000 of elective contributions and $7,500 of matching contributions. As a result, Employee J has received a higher effective rate of matching contributions than nonhighly compensated employees ($7,000 of elective contributions matched by $7,500 is an effective matching rate of 107 percent). If this amount remains in Employee J's account without correction, it will cause the plan to fail to satisfy section 401(a)(4), because only a highly compensated employee receives the higher matching contribution rate. The remaining $500 matching contribution may be forfeited (but not distributed) under section 411(a)(3)(G), if the plan so provides. The plan could instead correct the discriminatory rate of matching contributions by making additional allocations to the accounts of nonhighly compensated employees. See §1.401(a)(4)–11(g)(3)(vii)(B) and (6), *Example 7*.

(c) *Additional rules for prior year testing method*—(1) *Rules for change in testing method*. A plan is permitted to change from the prior year testing method to the current year testing method for any plan year. A plan is permitted to change from the current year testing method to the prior year testing method only in situations described in §1.401(k)–2(c)(1)(ii). For purposes of this paragraph (c)(1), a plan that uses the safe harbor method described in §1.401(m)–3 or a SIMPLE 401(k) plan is treated as using the current year testing method for that plan year

(2) *Calculation of ACP under the prior year testing method for the first plan year*—(i) *Plans that are not successor plans*. If, for the first plan year of any plan (other than a successor plan), a plan uses the prior year testing method, the plan is permitted to use either that first plan year as the applicable year for determining the ACP for the eligible NHCEs, or 3% as the ACP for eligible NHCEs, for applying the ACP test for that first plan year. A plan (other than a successor plan) that uses the prior year testing method but has elected for its first plan year to use that year as the applicable year for determining the ACP for the eligible NHCEs is not treated as changing its testing method in the second plan year and is not subject to the limitations on double counting under paragraph (a)(6)(vi) of this section for the second plan year.

(ii) *First plan year defined*. For purposes of this paragraph (c)(2), the first plan year of any plan is the first year in which the plan provides for employee contributions or matching contributions. Thus, the rules of this paragraph (c)(2) do not apply to a plan (within the meaning of §1.410(b)–7) for a plan year if for such plan year the plan is aggregated under §1.401(m)–1(b)(4) with any other plan that provides for employee or matching contributions in the prior year.

(iii) *Plans that are successor plans*. A plan is a successor plan if 50% or more of the eligible employees for the first plan year were eligible employees under another plan maintained by the employer in the prior year that provides for employee contributions or matching contributions. If a plan that is a successor plan uses the prior year testing method for its first plan year, the ACP for the group of NHCEs for the applicable year must be determined under paragraph (c)(4) of this section.

(3) *Plans using different testing methods for the ACP and ADP test*. Except as otherwise provided in this paragraph (c)(3), a plan may use the current year testing method or prior year testing method for the ACP test for a plan year without regard to whether the current year testing method or prior year testing method is used for the ADP test for that year. For example, a plan may use the prior year testing method for the ACP test and the current year testing method for its ADP test for the plan year. However, plans that use different testing methods under this paragraph (c)(3) cannot use —

(i) The recharacterization method of §1.401(k)–2(b)(3) to correct excess contributions for a plan year;

(ii) The rules of paragraph (a)(6)(ii) of this section to take elective contributions into account under the ACP test (rather than the ADP test); or

(iii) The rules of paragraph §1.401(k)–2(a)(6) to take qualified matching contributions into account under the ADP test (rather than the ACP test).

(4) *Rules for plan coverage change*—(i) *In general*. A plan that uses the prior year testing method that experiences a plan coverage change during a plan year satisfies the requirements of this section for that year only if the plan provides that the ACP for the NHCEs for the plan year is the weighted average of the ACPs for the prior year subgroups.

(ii) *Optional rule for minor plan coverage changes*. If a plan coverage change occurs and 90% or more of the total number of the NHCEs from all prior year subgroups are from a single prior year subgroup, then, in lieu of using the weighted averages described in paragraph (c)(4)(i) of this section, the plan may provide that the ACP for the group of eligible NHCEs for the prior year under the plan is the ACP of the NHCEs for the prior year of the plan under which that single prior year subgroup was eligible.

(iii) *Definitions*. The following definitions apply for purposes of this paragraph (c)(4)—

(A) *Plan coverage change*. The term *plan coverage change* means a change in the group or groups of eligible employees under a plan on account of—

(*1*) The establishment or amendment of a plan;

(*2*) A plan merger or spinoff under section 414(l);

(*3*) A change in the way plans (within the meaning of §1.410(b)–7) are combined or separated for purposes of §1.401(m)–1(b)(4) (*e.g.*, permissively aggregating plans not previously aggregated under §1.410(b)–7(d), or ceasing to permissively aggregate plans under §1.410(b)–7(d));

(*4*) A reclassification of a substantial group of employees that has the same effect as amending the plan (*e.g.*, a transfer of a substantial group of employees from one division to another division); or

(*5*) A combination of any of paragraphs (c)(4)(iii)(A)(*1*) through (*4*) of this section.

(B) *Prior year subgroup*. The term *prior year subgroup* means all NHCEs for the prior plan year who, in the prior year, were eligible employees under a specific plan that provides for employee contributions or matching contributions maintained by the employer and who would have been eligible employees in the prior year under the plan being tested if the plan coverage change had first been effective as of the first day of the prior plan year instead of first being effective during the plan year. The determination of whether an NHCE is a member of a prior year subgroup is made without regard to whether the NHCE terminated employment during the prior year.

(C) *Weighted average of the ACPs for the prior year subgroups*. The term *weighted average of the ACPs for the prior year subgroups* means the sum, for all prior year subgroups, of the adjusted ACPs for the plan year. The term *adjusted ACP with respect to a prior year subgroup* means the ACP for the prior plan year of the specific plan under which the members of the prior year subgroup were eligible employees on the first day of the prior plan year, multiplied by a fraction, the numerator of which is the number of NHCEs in the prior year subgroup and denominator of which is the total number of NHCEs in all prior year subgroups.

(iv) *Example*. The following example illustrate the application of this paragraph (c)(4). See also §1.401(k)–2(c)(4) for examples of the parallel rules applicable to the ADP test. The example is as follows:

Example. (i) Employer B maintains two plans, Plan N and Plan P, each of which provides for employee contributions or matching contributions. The plans were not permissively aggregated under § 1.410(b)–7(d) for the 2005 testing year. Both plans use the prior year testing method. Plan N had 300 eligible employees who were NHCEs for 2005, and their ACP for that year was 6%. Plan P had 100 eligible employees who were NHCEs for 2005, and the ACP for those NHCEs for that plan was 4%. Plan N and Plan P are permissively aggregated under § 1.410(b)–7(d) for the 2006 plan year.

(ii) The permissive aggregation of Plan N and Plan P for the 2006 testing year under § 1.410(b)–7(d) is a plan coverage change that results in treating the plans as one plan (Plan NP). Therefore, the prior year ACP for the NHCEs under Plan NP for the 2006 testing year is the weighted average of the ACPs for the prior year subgroups.

(iii) The first step in determining the weighted average of the ACPs for the prior year subgroups is to identify the prior year subgroups. With respect to the 2006 testing year, an employee is a member of a prior year subgroup if the employee was an NHCE of Employer B for the 2005 plan year, was an eligible employee for the 2005 plan year under any section 401(k) plan maintained by Employer B, and would have been an eligible employee in the 2005 plan year under Plan NP if Plan N and Plan P had been permissively aggregated under §1.410(b)–7(d) for that plan year. The NHCEs who were eligible employees under separate plans for the 2005 plan year comprise separate prior year subgroups. Thus, there are two prior year subgroups under Plan NP for the 2006 testing year: the 300 NHCEs who were eligible employees under Plan N for the 2005 plan year and the 100 NHCEs who were eligible employees under Plan P for the 2005 plan year.

(iv) The weighted average of the ACPs for the prior year subgroups is the sum of the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N, and the adjusted ACP with respect to the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan N is 4.5%, calculated as follows: 6% (the ACP for the NHCEs under Plan N for the prior year) x 300/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 4.5%. The adjusted ACP for the prior year subgroup that consists of the NHCEs who were eligible employees under Plan P is 1%, calculated as follows: 4% (the ACP for the NHCEs under Plan P for the prior year) x 100/400 (the number of NHCEs in that prior year subgroup divided by the total number of NHCEs in all prior year subgroups), which equals 1%. Thus, the prior year ACP for NHCEs under Plan NP for the 2006 testing year is 5.5% (the sum of adjusted ACPs for the prior year subgroups, 4.5% plus 1%).

§1.401(m)–3 Safe harbor requirements.

(a) *ACP test safe harbor*. Matching contributions under a plan satisfy the ACP safe harbor provisions of section 401(m)(11) for a plan year if the plan satisfies the safe harbor contribution requirement of paragraphs (b) or (c) of this section for the plan year, the limitations on matching contributions of paragraph (d) of this section, the notice requirement of paragraph (e) of this section, the plan year requirements of paragraph (f) of this section, and the additional rules of paragraphs (g), (h) and (j) of this section, as applicable. Pursuant to section 401(k)(12)(E)(ii), the safe harbor contribution requirement of paragraphs (b) and (c) of this section must be satisfied without regard to section 401(l). The contributions made under paragraphs (b) and (c) of this section are referred to as safe harbor nonelective contributions and safe harbor matching contributions, respectively.

(b) *Safe harbor nonelective contribution requirement*. A plan satisfies the safe harbor nonelective contribution requirement of this paragraph (b) if it satisfies the safe harbor nonelective contribution requirement of §1.401(k)–3(b).

(c) *Safe harbor matching contribution requirement*. A plan satisfies the safe harbor matching contribution requirement of this paragraph (c) if it satisfies the safe harbor matching contribution requirement of §1.401(k)–3(c).

(d) *Limitation on contributions*–(1) *General rule*. A plan that provides for matching contributions meets the requirements of this section only if it satisfies the limitations on contributions set forth in this paragraph (d).

(2) *Matching rate must not increase*. A plan that provides for matching contributions meets the requirements of this paragraph (d) only if the ratio of matching contributions on behalf of an employee under the plan for a plan year to the employee's elective deferrals and employee contributions, does not increase as the amount of an employee's elective deferrals and employee contributions increases.

(3) *Limit on matching contributions*. A plan that provides for matching contributions satisfies the requirements of this section only if—

(i) Matching contributions are not made with respect to elective deferrals or employee contributions that exceed 6% of the employee's safe harbor compensation (within the meaning of §1.401(k)–3(b)(2)); and

(ii) Matching contributions that are discretionary do not exceed 4% of the employee's safe harbor compensation.

(4) *Limitation on rate of match*. A plan meets the requirements of this section only if the ratio of matching contributions on behalf of an HCE to that HCE's elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) for that plan year is no greater than the ratio of matching contributions to elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) that would apply with respect to any NHCE for whom the elective deferrals or employee contributions (or the sum of elective deferrals and employee contributions) are the same percentage of safe harbor compensation. An employee is taken into account for purposes of this paragraph (d)(4) if the employee is an eligible employee under the cash or deferred arrangement with respect to which the contributions required by paragraph (b) or (c) of this section are being made for a plan year. A plan will not fail to satisfy this paragraph (d)(4) merely because the plan provides that matching contributions will be made separately with respect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of a plan year) taken into account under the plan for the plan year, provided that matching contributions with respect to any elective deferrals or employee contributions made during a plan year quarter are contributed to the plan by the last day of the immediately following plan year quarter.

(5) *HCEs participating in multiple plans*. The rules of section 401(m)(2)(B) and §1.401(m)–2(a)(3)(ii) apply for purposes of determining the rate of matching contributions under paragraph (d)(4) of this section. However, a plan will not fail to satisfy the safe harbor matching contribution requirements of this section merely because an HCE participates during the plan year in more than one plan that provides for matching contributions, provided that —

(i) The HCE is not simultaneously an eligible employee under two plans that provide for matching contributions maintained by an employer for a plan year; and

(ii) The period used to determine compensation for purposes of determining matching contributions under each such plan is limited to periods when the HCE participated in the plan.

(6) *Permissible restrictions on elective deferrals by NHCEs*—(i) *General rule*. A plan does not satisfy the safe harbor requirements of this section, if elective deferrals or employee contributions by NHCEs are restricted, unless the restrictions are permitted by this paragraph (d)(6).

(ii) *Restrictions on election periods*. A plan may limit the frequency and duration of periods in which eligible employees may make or change contribution elections under a plan. However, an employee must have a reasonable opportunity (including a reasonable period after receipt of the notice described in paragraph (e) of this section) to make or change a contribution election for the plan year. For purposes of this section, a 30-day period is deemed to be a reasonable period to make or change a contribution election.

(iii) *Restrictions on amount of contributions*. A plan is permitted to limit the amount of contributions that may be made by an eligible employee under a plan, provided that each NHCE who is an eligible employee is permitted (unless the employee is restricted under paragraph (d)(6)(v) of this section) to make contributions in an amount that is at least sufficient to receive the maximum amount of matching contributions available under the plan for the plan year, and the employee is permitted to elect any lesser amount of contributions. However, a plan may require eligible employees to make contribution elections in whole percentages of compensation or whole dollar amounts.

(iv) *Restrictions on types of compensation that may be deferred*. A plan may limit the types of compensation that may be deferred or contributed by an eligible employee under a plan, provided that each eligible NHCE is permitted to make contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of §1.414(s)–1(d)(2). Thus, the definition of compensation from which contributions may be made is not required to satisfy the nondiscrimination requirement of §1.414(s)–1(d)(3).

(v) *Restrictions due to limitations under the Internal Revenue Code*. A plan may limit the amount of contributions made by an eligible employee under a plan—

(A) Because of the limitations of section 402(g) or section 415; or

(B) Because, on account of a hardship distribution, an employee's ability to make contributions has been suspended for 6 months in accordance with §1.401(k)–1(d)(3)(iv)(E).

(e) *Notice requirement*. A plan satisfies the notice requirement of this paragraph (e) if it satisfies the notice requirement of §1.401(k)–3(d).

(f) *Plan year requirement* —(1) *General rule*. Except as provided in this paragraph (f) or in paragraph (g) of this section, a plan will fail to satisfy the requirements of section 401(m)(11) and this section unless plan provisions that satisfy the rules of this section are adopted before the first day of that plan year and remain in effect for an entire 12-month plan year. Moreover, if, as described in paragraph (j)(4) of this section, safe harbor matching or nonelective contributions will be made to another plan for a plan year, provisions specifying that the safe harbor contributions will be made in the other plan and providing that the contributions will be QNECs or QMACs must be also be adopted before the first day of that plan year.

(2) *Initial plan year*. A newly established plan (other than a successor plan within the meaning of §1.401(m)–2 (c)(2)(iii)) will not be treated as violating the requirements of this paragraph (f) merely because the plan year is less than 12 months, provided that the plan year is at least 3 months long (or, in the case of a newly established employer that establishes the plan as soon as administratively feasible after the employer comes into existence, a shorter period). Similarly, a plan will not fail to satisfy the requirements of this paragraph (f) for the first plan year in which matching contributions are provided under the plan provided that—

(i) The plan is not a successor plan; and

(ii) The amendment providing for matching contributions is made effective at the same time as the adoption of a cash or deferred arrangement that satisfies the requirements of §1.401(k)–3, taking into account the rules of §1.401(k)–3(e)(2).

(3) *Change of plan year*. A plan that has a short plan year as a result of changing its plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the plan year has less than 12 months, provided that—

(i) The plan satisfied the requirements of this section for the immediately preceding plan year; and

(ii) The plan satisfies the requirements of this section for the immediately following plan year.

(4) *Final plan year*. A plan that terminates during a plan year will not fail to satisfy the requirements of paragraph (f)(1) of this section merely because the final plan year is less than 12 months, provided that—

(i) The plan would satisfy the requirements of paragraph (h) of this section, treating the termination of the plan as a reduction or suspension of safe harbor matching contributions, other than the requirement that employees have a reasonable opportunity to change their cash or deferred elections and, if applicable, employee contribution elections; or

(ii) The plan termination is in connection with a transaction described in section 410(b)(6)(C) or the employer incurs a substantial business hardship, comparable to a substantial business hardship described in section 412(d).

(g) *Plan amendments adopting nonelective safe harbor contributions*. Notwithstanding paragraph (f)(1) of this section, a plan that provides for the use of the current year testing method may be amended after the first day of the plan year and no later than 30 days before the last day of the plan year to adopt the safe harbor method of this section using nonelective contributions under paragraph (b) of this section if the plan satisfies the requirements of §1.401(k)–3(f).

(h) *Permissible reduction or suspension of safe harbor matching contributions*—(1) *General rule*. A plan that provides for safe harbor matching contributions will not fail to satisfy the requirements of section 401(m)(2) for a plan year merely because the plan is amended during a plan year to reduce or suspend safe harbor matching contributions on future elective deferrals and, if applicable, employee contributions provided—

(i) All eligible employees are provided the supplemental notice in accordance with paragraph (h)(2) of this section;

(ii) The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of 30 days after eligible employees are provided the notice described in paragraph (h)(2) of this section and the date the amendment is adopted;

(iii) Eligible employees are given a reasonable opportunity (including a reasonable period after receipt of the supplemental notice) prior to the reduction or suspension of safe harbor matching contributions to change their cash or deferred elections and, if applicable, their employee contribution elections;

(iv) The plan is amended to provide that the ACP test will be satisfied for the entire plan year in which the reduction or suspension occurs using the current year testing method described in §1.401(m)–2(a)(1)(ii); and

(v) The plan satisfies the requirements of this section (other than this paragraph (h)) with respect to amounts deferred through the effective date of the amendment.

(2) *Notice of suspension requirement*. The notice of suspension requirement of this paragraph (h)(2) is satisfied if each eligible employee is given a written notice that satisfies the content requirements of §1.401(k)–3(e)(3).

(i) [Reserved]

(j) *Other rules*—(1) *Contributions taken into account*. A contribution is taken into account for purposes of this section for a plan year under the same rules as §1.401(k)–3(h)(1).

(2) *Use of safe harbor nonelective contributions to satisfy other nondiscrimination tests*. A safe harbor nonelective contribution used to satisfy the nonelective contribution requirement under paragraph (b) of this section may also be taken into account for purposes of determining whether a plan satisfies section 401(a)(4) under the same rules as §1.401(k)–3(h)(2).

(3) *Early participation rules*. Section 401 (m)(5)(C) and §1.401(m)–2(a)(1)(iii)(A) which provide an alternative nondiscrimination rule for certain plans that provide for early participation, does not apply for purposes of section 401(m)(11) and this section. Thus, a plan is not treated as satisfying this section with respect to the eligible employees who have not completed the minimum age and service requirements of section 410(a)(1)(A) unless the plan satisfies the requirements of this section with respect to such eligible employees.

(4) *Satisfying safe harbor contribution requirement under another defined contribution plan*. Safe harbor matching or nonelective contributions may be made to another defined contribution plan under the same rules as §1.401(k)–3(h)(4). Consequently, each NHCE under the plan providing for matching contributions must be eligible under the same conditions under the other defined contribution plan and the plan to which the contributions are made must have the same plan year as the plan providing for matching contributions.

(5) *Contributions used only once*. Safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of this section with respect to more than one plan.

(6) *Plan must satisfy ACP with respect to employee contributions*. If the plan provides for employee contributions, in addition to satisfying the requirements of this section, it must also satisfy the ACP test of §1.401(m)–2. See §1.401(m)–2(a)(5)(iii) for specials rules under which the ACP test is permitted to be run taking into account only employee contributions when

this section is satisfied with respect to the matching contributions.

§1.401(m)–4 Special rules for mergers, acquisitions and similar events. [Reserved]

§1.401(m)–5 Definitions.

Unless otherwise provided, the definitions of this section govern for purposes of section 401(m) and the regulations thereunder.

Actual contribution percentage (ACP). Actual contribution percentage or *ACP* means the ACP of the group of eligible employees as defined in §1.401(m)–2(a)(2)(i).

Actual contribution percentage (ACP) test. Actual contribution percentage test or *ACP test* means the test described in §1.401(m)–2(a)(1).

Actual contribution ratio (ACR). Actual contribution ratio or *ACR* means the ACR of an eligible employee as defined in §1.401(m)–2(a)(3).

Actual deferral percentage (ADP) test. Actual deferral percentage test or *ADP test* means the test described in §1.401(k)–2(a)(1).

Compensation. Compensation means compensation as defined in section 414(s) and §1.414(s)–1. The period used to determine an employee's compensation for a plan year must be either the plan year or the calendar year ending within the plan year. Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for that plan year. A plan may, however, limit the period taken into account under either method to that portion of the plan year or calendar year in which the employee was an eligible employee, provided that this limit is applied uniformly to all eligible employees under the plan for the plan year. See also section 401(a)(17) and §1.401(a)(17)–1(c)(1). For this purpose, in case of an HCE whose ACR is determined under §1.401(m)–2(a)(3)(ii), period of participation includes periods under another plan for which matching contributions or employee contributions are aggregated under §1.401(m)–2(a)(3)(ii).

Current year testing method. Current year testing method means the testing method under which the applicable year is the current plan year, as described in §1.401(m)–2(a)(2)(ii) or 1.401(k)–2(a)(2)(ii).

Elective contributions. Elective contributions means elective contributions as defined in §1.401(k)–6.

Elective deferrals. Elective deferrals means elective deferrals described in section 402(g)(3).

Eligible employee—(1) *General rule. Eligible employee* means an employee who is directly or indirectly eligible to make an employee contribution or to receive an allocation of matching contributions (including matching contributions derived from forfeitures) under the plan for all or a portion of the plan year. For example, if an employee must perform purely ministerial or mechanical acts (*e.g.*, formal application for participation or consent to payroll withholding) in order to be eligible to make an employee contribution for a plan year, the employee is an eligible employee for the plan year without regard to whether the employee performs these acts.

(2) *Conditions on eligibility*. An employee who is unable to make employee contributions or to receive an allocation of matching contributions because the employee has not contributed to another plan is also an eligible employee. By contrast, if an employee must perform additional service (*e.g.*, satisfy a minimum period of service requirement) in order to be eligible to make an employee contribution or to receive an allocation of matching contributions for a plan year, the employee is not an eligible employee for the plan year unless the service is actually performed. An employee who would be eligible to make employee contributions but for a suspension due to a distribution, a loan, or an election not to participate in the plan, is treated as an eligible employee for purposes of section 401(m) for a plan year even though the employee may not make employee contributions or receive an allocation of matching contributions by reason of the suspension. Finally, an employee does not fail to be treated as an eligible employee merely because the employee may receive no additional annual additions because of section 415(c)(1).

(3) *Certain one-time elections*. An employee is not an eligible employee merely because the employee, upon commencing employment with the employer or upon the employee's first becoming eligible under any plan of the employer providing for employee or matching contributions, is given a one-time opportunity to elect, and the employee in fact does elect, not to be eligible to make employee contributions or to receive allocations of matching contributions under the plan or any other plan maintained by the employer (including plans not yet established) for the duration of the employee's employment with the employer. In no event is an election made after December 23, 1994, treated as one-time irrevocable election under this paragraph if the election is made by an employee who previously became eligible under another plan (whether or not terminated) of the employer.

Eligible HCE. Eligible HCE means an eligible employee who is an HCE.

Eligible NHCE. Eligible NHCE means an eligible employee who is not an HCE.

Employee. Employee means an employee within the meaning of §1.410(b)–9.

Employee contributions. Employee contributions means employee contributions as defined in 1.401(m)–1(a)(3).

Employee stock ownership plan (ESOP). Employee stock ownership plan or *ESOP* means the portion of a plan that is an ESOP within the meaning of §1.410(b)–7(c)(2).

Employer. Employer means an employer within the meaning of §1.410(b)–9.

Excess aggregate contributions. Excess aggregate contributions means, with respect to a plan year, the amount of excess aggregate contributions apportioned to an HCE under §1.401(m)–2(b)(2)(iii).

Excess contributions. Excess contribution means with respect to a plan year, the amount of excess contribution apportioned to an HCE under §1.401(k)–2(b)(2)(iii).

Excess deferrals. Excess deferrals means excess deferrals as defined in §1.402(g)–1(e)(3).

Highly compensated employee (HCE). Highly compensated employee or *HCE* has the meaning provided in section 414(q).

Matching contributions. Matching contribution is defined in §1.401(m)–1(a)(2).

Nonelective contributions. Nonelective contributions means employer contributions (other than matching contributions) with respect to which the employee may not elect to have the contributions paid to the employee in cash or other benefits instead of being contributed to the plan.

Non-employee stock ownership plan (non-ESOP). Non-employee stock ownership plan or *non-ESOP* means the portion of a plan that is not an ESOP within the meaning of §1.410(b)–7(c)(2).

Non-highly compensated employee (NHCE). Non-highly compensated employee or *NHCE* means an employee who is not an HCE.

Plan. Plan means plan as defined in §1.401(m)–1(b)(4).

Prior year testing method. Prior year testing method means the testing method under which the applicable year is the prior plan year, as described in §1.401(m)–2(a)(2)(ii) or §1.401(k)–2(a)(2)(ii).

Qualified matching contributions (QMAC). Qualified matching contributions or *QMAC* means matching contributions that satisfy the requirements of §1.401(k)–1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account as elective contributions under §1.401(k)–2(a)(6). See also §1.401(k)–2(b)(4)(iii) for a rule providing that a matching contribution does not fail to qualify as a QMAC solely because it is forfeitable under section 411(a)(3)(G) because it is a matching contribution with respect to an excess deferral, excess contribution, or excess aggregate contribution.

Qualified nonelective contributions (QNEC). Qualified nonelective contributions or *QNEC* means employer contributions, other than elective contributions or matching contributions, that satisfy the requirements of §1.401(k)–1(c) and (d) at the time the contribution is made, without regard to whether the contributions are actually taken into account under the ADP test under §1.401(k)–2(a)(6) or the ADP test under §1.401(m)–2(a)(6).

Judith B. Tomaso,
Acting Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 16, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 17, 2003, 68 F.R. 42475)

Notice of Proposed Rulemaking; Notice of Public Hearing; and Withdrawal of Previously Proposed Regulations

Credit for Increasing Research Activities

REG–133791–02 and REG–105606–99

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking; notice of public hearing; and withdrawal of previously proposed regulations.

SUMMARY: This document contains proposed regulations relating to the computation and allocation of the credit for increasing research activities for members of a controlled group of corporations or a group of trades or businesses under common control. These proposed regulations reflect changes made to section 41 by the Revenue Reconciliation Act of 1989 and the Small Business Job Protection Act of 1996, which introduced the alternative incremental research credit. This document also provides notice of a public hearing on these proposed regulations and withdraws the proposed regulations (REG–105606–99, 2000–1 C.B. 421 [65 FR 258]) published in the Federal Register on January 4, 2000.

DATES: Written or electronic comments must be received by October 23, 2003. Requests to speak and outlines of the topics to be discussed at the public hearing scheduled for November 13, 2003, at 10 a.m. must be received by October 23, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–133791–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may also be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–133791–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically via the Internet by submitting comments directly to the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC 20224.

FOR FURTHER INFORMATION CONTACT: Concerning these proposed regulations, Jolene J. Shiraishi at (202) 622–3120 (not a toll-free call); concerning submissions of comments, the hearing, and to be placed on the building access list to attend the hearing, Guy Traynor at (202) 622–7180 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On January 4, 2000, Treasury and the IRS published in the **Federal Register** (REG–105606–99, 2000–1 C.B. 421 [65 FR 258]) proposed amendments to the regulations under section 41(f) (2000 proposed regulations) relating to the computation and allocation of the credit for increasing research activities (research credit) for members of a controlled group of corporations or a group of trades or businesses under common control (controlled group). The 2000 proposed regulations reflected changes made to section 41 by the Revenue Reconciliation Act of 1989 (the 1989 Act) and the Small Business Job Protection Act of 1996. Treasury and the IRS received written comments from two commentators. A public hearing was held on April 26, 2000. After considering the written comments and the statements at the public hearing, Treasury and the IRS are withdrawing the 2000 proposed regulations and are proposing new regulations.

Summary of Comments and Explanation of Provisions

Overview

These new proposed regulations for members of a controlled group under section 41(f) follow the research credit computation rule contained in the 2000 proposed regulations. The computation of the research credit for a controlled group (group credit) under these new proposed regulations is done by treating all of the members of a controlled group as a single taxpayer. Unlike the 2000 proposed regulations, these new proposed regulations then allocate the group credit among the members of the controlled group based on the relative amounts of each individual member's stand-alone entity credit — the credit, if any, that a member of a controlled group would be entitled to claim if it were not a member of a controlled group. These new proposed regulations generally will apply to taxable years beginning on or after the date that final regulations are published in the **Federal Register**.

Computation of the Group Credit

Section 41(f)(1)(A)(i) provides that in determining the amount of the research credit under section 41, "all members of the same controlled group of corporations shall be treated as a single taxpayer." Section 41(f)(1)(B)(i) provides a similar rule for a group of trades or businesses under common control. Accordingly, for purposes of determining the amount of the group credit, the 2000 proposed regulations applied all of the section 41 computational rules on an aggregate basis. The commentators agreed that with respect to the computation of the group credit, the 2000 proposed regulations are consistent with the provisions of section 41(f). These new proposed regulations, therefore, do not change the method for computing the group credit. These new proposed regulations, however, clarify the application of the start-up company rules under section 41(c)(3)(B) to a controlled group with respect to the computation of the group credit.

Allocation of the Group Credit Among Members of the Controlled Group

Section 41(f)(1)(A)(ii) provides that "the [portion of the group] credit (if any) allowable by this section to each such member shall be its proportionate shares of the qualified research expenses and basic research payments giving rise to the credit." Section 41(f)(1)(B)(ii) provides a similar rule for a group of trades or businesses under common control. These new proposed regulations apply these provisions by allocating the group credit based on the relative amounts of each individual member's stand-alone entity credit.

2000 Proposed Regulations

The 2000 proposed regulations allocated the group credit based on the amounts by which each individual member's qualified research expenses (QREs) exceeded a base amount for that member. An individual member's base amount, for purposes of allocating the group credit under the 2000 proposed regulations, was determined by applying the controlled group's fixed-base percentage to the member's average annual gross receipts for the four taxable years preceding the credit year. The group credit was allocated to a member having an excess amount of QREs by multiplying the group credit by a fraction having the individual member's excess amount as the numerator and the aggregate excess amount of all the members of the controlled group as the denominator. A similar allocation method was provided for the credit for basic research payments and for the alternative incremental research credit.

The preamble to the 2000 proposed regulations stated that the purpose of this method was to allocate the group credit to "those members whose share of current year qualified research expenses exceeds their share of the [controlled group's] base amount." In particular, the preamble noted that in providing a rule that reflects the incremental nature of the research credit, Treasury and the IRS declined to follow comments noting that amendments to section 41 made by the 1989 Act required that the allocation of the group credit be based on the relative amounts of total QREs incurred separately by members of the controlled group:

> In proposing rules for the allocation of the credit, Treasury and the IRS considered, but were not persuaded by, certain taxpayers' argument that the elimination of the word "increase" from the allocation rule in the statute requires that the credit be allocated on the basis of the gross amount of qualified research expenses incurred by the various members of the controlled group. Treasury and the IRS believe that elimination of the word "increase" was necessitated by the 1989 statutory amendments to the computation of the research credit, which afford a credit in certain circumstances even where the taxpayer (or each member of a controlled group) is decreasing its gross amount of qualified research expenses (*e.g.*, because the taxpayer's gross receipts also are decreasing). However, there is no indication that the elimination of the word "increase" was intended to suggest that the credit be allocated without regard to its incremental nature. To the contrary, the statutory prescription that the credit be allocated according to each member's proportionate share of the qualified research expenses "giving rise to" the credit supports a rule that allocates the credit to those members whose share of current year qualified research expenses exceeds their share of the base amount.

Comments on the 2000 Proposed Regulations

Two commentators submitted a series of comments in response to the 2000 proposed regulations. As noted above, both commentators agreed that the method for computing the group credit contained in the 2000 proposed regulations is consistent with the provisions of section 41(f). The commentators diverged significantly, however, with respect to the method for allocating the group credit. The first commentator supported the allocation rule contained in the 2000 proposed regulations. The second commentator reiterated the earlier expressed view that the allocation of the group credit should be done on the basis of each member's total QREs (gross QREs method).

The second commentator set out a number of reasons why a gross QREs method should be adopted instead of the method contained in the 2000 proposed regulations. In particular, the commentator stated that a gross QREs method is the only method consistent with the plain meaning of section 41(f). As a related point, the commentator claimed that a statutory amendment made by the 1989 Act supports its plain meaning argument. The commentator also noted that the allocation method contained in the 2000 proposed regulations, by incorporating both individual member and controlled group elements, was at odds with the computation method provided by the statute and failed to allocate rationally the group credit.

Treasury and the IRS continue to believe that, compared to a gross QREs method, an allocation method based on a group member's QREs in excess of a base amount more fully carries out the purposes of section 41 in general and the section 41(f) controlled group credit rules. The research credit is not, and has never been, a credit computed as a percentage of total qualifying expenses. Rather, the research credit generally is allowed only when a taxpayer's QREs exceed a base amount. Prior to the 1989 Act, the research credit was computed by multiplying the credit rate by the excess of the taxpayer's current year QREs over the taxpayer's average QREs for the preceding three years. The 1989 Act significantly modified the computation of the research credit while retaining the incremental approach of the pre-1989 Act credit. In general, the research credit computation is based on whether and the extent to which a taxpayer increases the proportion of its QREs relative to its recent gross receipts, compared to a historical base period. Ultimately, this computation measures the extent to which a taxpayer's current year QREs exceed a base amount.

Treasury and the IRS conclude that the controlled group allocation rules set out in section 41(f) were not intended to result in the allocation of the group credit to individual members of the group in a manner wholly at odds with the incremental nature of the research credit. The legislative history to the research credit, as originally enacted in 1981, indicates that the group credit rules were enacted to ensure that the research credit would be allowed only for actual increases in research expenditures. These rules were intended to prevent taxpayers from creating artificial increases in research expenditures by shifting expenditures among commonly controlled or otherwise related persons. H. Rep. No. 97–201, 1981–2 C.B. (Vol. 2) 364, and S. Rep. 97–144, 1981–2 C.B. (Vol. 2) 442. In effect, the group credit computation rule serves as a cap on the maximum amount of credit that the members of the group, in the aggregate, may claim. A rule that then allocates the group credit based solely on the total amount of QREs incurred by each individual member, however, would be inconsistent with the incremental nature of the credit and would not further the purpose of the section 41(f) group credit rules.

As during the consideration of the 2000 proposed regulations, Treasury and the IRS do not find persuasive the second commentator's argument that a plain reading of the statute, following the deletion of the phrase "increase in" in sections 41(f)(1)(A)(ii) and 41(f)(1)(B)(ii) by the 1989 Act, mandates a gross QREs method for allocating the group credit. Prior to the 1989 Act, for example, section 41(f)(1)(A)(ii) provided that the research credit, if any, allowable to each member of a controlled group was the member's "proportionate share of the increase in qualified research expenses giving rise to the credit." The phrase "increase in" was deleted by the 1989 Act. The commentator maintained that a gross QREs method gives effect to the phrase "giving rise to the credit" as well as to the deletion of the phrase "increase in" from the statute by the 1989 Act because "each dollar of the group's QREs gives rise to [the] excess over the group's base amount" or "(s)tated otherwise, if you eliminate a dollar of qualified research expenses from any member of the group, the group's credit will be reduced proportionately."

The reason for the deletion of the phrase "increase in" is not addressed in the legislative history to the 1989 Act. The changes to the computation of the research credit made by the 1989 Act, however, made a taxpayer's QREs for prior years, other than taxable years beginning after December 31, 1983, and before January 1, 1989 (base years), irrelevant to the computation of the credit. Instead, the amount of the research credit now depends on whether and the extent to which a taxpayer increases the proportion (compared to that of the base years) of its QREs relative to its average annual gross receipts from the prior four years. Accordingly, although the research credit is still based on the amount by which current year QREs exceed a base amount, that base amount, unlike the general research credit computation prior to the 1989 Act, is not a rolling average of QREs incurred in the three years prior to the credit year. Treasury and the IRS, therefore, conclude that the deletion of the phrase "increase in" was intended to reflect this change, and not to indicate that the allocation of the group credit was to be made using a gross QREs method.

The second commentator noted, in arguing that the allocation method in the 2000 proposed regulations impermissibly mixed controlled group and individual member calculations, that the allocation method favors those members whose current ratio of QREs to recent gross receipts exceeds the controlled group's fixed-base percentage, regardless of whether that member's ratio, in fact, was increasing or decreasing. As stated by the commentator, "[t]he group's fixed-base percentage can be wildly different from the fixed-base percentage for an individual member depending on the individual member's separate QREs and separate gross receipts during the [base years]. In other words, the amount of group credit that would be allocated to an individual member under the 2000 proposed regulations may bear little or no relationship to what the individual member would be entitled to on a stand-alone basis, depending on how similar the individual member's separate fixed-base percentage was to the group's fixed-base percentage.

Proposed Allocation Rule

After considering the statute, the legislative history, the written comments, and the statements at the public hearing, Treasury and the IRS have determined that the allocation method contained in the 2000 proposed regulations does not fully carry out the purpose of the research credit statute and, in particular, the amendments made by the 1989 Act. Treasury and the IRS continue to believe that the method for allocating the group credit must take into account the incremental nature of the credit. In considering the consequences of the allocation method contained in the 2000 proposed regulations, as highlighted by the commentators, Treasury and the IRS believe that the method may not, in certain cases, appropriately balance the purpose of the group credit computation and allocation rules contained in section 41(f) with the general purpose of the research credit, which is to encourage research activities.

Accordingly, these new proposed regulations allocate the group credit among the members of the controlled group by first computing each individual member's stand-alone entity credit and then multiplying the group credit by the ratio that the member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the controlled group. This new allocation method ensures that the amount of group credit allocated to each individual member will be proportionate to the amount of research credit that the individual member would have been entitled to claim had it not been part of a controlled group. This new allocation method therefore addresses the concerns expressed by the commentators that the allocation method contained in the 2000 proposed regulations could result in individual members receiving little or no research credit — or, conversely, a disproportionately greater amount of research credit — compared to what they would have been entitled to on a stand-alone basis, solely as a result of being part of a controlled group.

Special Allocation Rule for Consolidated Groups

In the preamble to the 2000 proposed regulations, Treasury and the IRS requested comments with respect to a special rule that would treat all members of a consolidated group within a controlled group as a single member for purposes of allocating the group credit among the members of a controlled group. After considering the comments received, Treasury and the IRS have decided not to propose a special allocation rule for consolidated groups.

Effective Date

The 2000 proposed regulations provided that they would be effective, when finalized, for taxable years ending on or after the date the proposed regulations were filed with the **Federal Register** (*i.e.*, December 29, 1999). The 2000 proposed regulations, however, were proposed to be retroactive in certain instances to prevent abuse:

> To prevent taxpayers that are members of a controlled group from together claiming in excess of 100% of the credit with respect to prior taxable years, the rules for allocating the group credit would apply to any taxable year beginning after December 31, 1989, in which, as a result of inconsistent methods of allocation, the members of a controlled group as a whole claimed more than 100% of the allowable group credit. In the case of a group whose members have different taxable years and whose members used inconsistent methods of allocation, the members of the group as a whole shall be deemed to have claimed more than 100% of the allowable group credit.

The two commentators disagreed as to the appropriateness of this proposed effective date. In particular, the second commentator stated that it would be "unconscionable" for final regulations containing the allocation method set out in the 2000 proposed regulations to be applied retroactively. The second commentator therefore proposed that final regulations be applied prospectively and that for prior years, taxpayers be permitted to rely on final regulations or any other method that is reasonable, including a gross QREs method. Finally, the second commentator disputed "that there is a potential for abuse if members of a controlled group take inconsistent methods of allocation for past years. The fact that members of the same controlled group may, in the aggregate, claim more than 100% of the group's Research Credit should not make any difference."

The group credit rules in section 41(f) provide for a total group credit. There is nothing in the statute or the legislative history that suggests that it then should be permissible for the members of the controlled group to claim, in the aggregate, an amount of research credit exceeding the group credit. Treasury and the IRS continue to believe that the purpose of the section 41(f) group credit rules would be undermined if the members of a controlled group applied different allocation methods to claim more than 100 percent of the group credit. The preamble to the 2000 proposed regulations and those proposed regulations themselves eliminated any ambiguity that may have existed with respect to the Treasury and IRS position on this point.

Accordingly, Treasury and the IRS propose that final regulations be effective for taxable years beginning on or after the date that these regulations are published in the **Federal Register** as final regulations. Treasury and the IRS further propose that the final regulations be retroactive in limited circumstances to prevent abuse. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations. However, paragraph (b) relating to the computation of the group credit and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Special Analyses

It has been determined that these proposed regulations do not constitute a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) and the Regulatory Flexibility Act (5 U.S.C. chapter 6) do not apply to these proposed regulations. Pursuant to section 7805(f) of the Internal Revenue Code, these proposed regulations will be submitted to the Administrator of the Small Business Administration for comment on their impact on small business.

* * * * *

Withdrawal of Proposed Amendments to the Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–105606–99, 2000–1 C.B. 421 [65 FR 258]) published in the **Federal Register** on January 4, 2000, is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. In §1.41–0, the table of contents is amended as follows:

1. The entry for §1.41–6(a)(4) is revised.

2. The entries for §1.41–6(b) through (e) are revised.

3. New entries are added for §1.41–6(f) through (i).

The revisions and additions read as follows:

§1.41–0 Table of contents.

* * * * *

§1.41–6 Aggregation of expenditures.

* * * * *

Par. 3. Section 1.41–6 is amended as follows:

1. Paragraph (a)(1) is revised.
2. Paragraph (a)(4) is revised.
3. Paragraph (b) is revised.
4. Paragraphs (c), (d), and (e) are redesignated as paragraph (f), (g), and (h), respectively.
5. New paragraphs (c), (d), and (e) are added.
6. Newly designated paragraph (f)(1) is revised.
7. New paragraph (i) is added.

The revisions and additions read as follows:

§1.41–6 Aggregation of expenditures.

(a) * * * (1) *In general*. To determine the amount of research credit (if any) allowable to a trade or business that at the end of its taxable year is a member of a controlled group of corporations or a group of trades or businesses under common control, a taxpayer must —

(i) Compute the group credit in the manner described in paragraph (b) of this section, and

(ii) Allocate the group credit among the members of the group in the manner described in paragraph (c) of this section.

* * * * *

(4) *Definition of group credit*. For purposes of this section, the term *group credit* means the research credit (if any) allowable to a controlled group of corporations or a group of trades or businesses under common control.

(b) *Computation of the group credit* — (1) *In general*. All members of a controlled group of corporations or a group of trades or businesses under common control are treated as a single taxpayer for purposes of computing the research credit. The group credit is computed by applying all of the section 41 computational rules on an aggregate basis.

(2) *Start-up companies*. A controlled group of corporations or a group of trades or businesses under common control is treated as a start-up company for purposes of determining the group's fixed-base percentage under section 41(c)(3)(B)(ii) only if each member of the group qualifies as a start-up company under section 41(c)(3)(B)(i).

(c) *Allocation of the group credit* — (1) *In general*. To determine the amount of the group credit (if any) computed under paragraph (b) of this section that is allocated to a member of the group, a taxpayer must —

(i) Compute the member's stand-alone entity credit; and

(ii) Multiply the group credit by the ratio that the member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group:

$$\text{group credit} \times \frac{\text{member's stand-alone entity credit}}{\text{sum of all the members' stand-alone entity credits}}$$

(2) *Stand-alone entity credit*. For purposes of this section, the term *stand-alone entity credit* means the research credit (if any) that would be allowable to a member of a group if the credit were computed without regard to section 41(f). In computing a member's stand-alone entity credit, a taxpayer must use the same method (*i.e.*, the computation method provided in section 41(a) or the elective method provided in section 41(c)(4)) that was used to compute the group credit. Therefore, if the research credit determined under section 41(a) is not allowable to the group and the group credit is computed using the alternative incremental research credit (AIRC) rules of section 41(c)(4), each member's stand-alone entity credit also must be computed using the AIRC rules, even if the research credit determined under section 41(a) would be allowable to a member if that member were not a part of the group.

(d) *Examples*. The following examples illustrate the provisions of this section:

Example 1. Research credit — (i) *Facts*. A, B, and C, all of which are calendar-year taxpayers, are members of a controlled group of corporations. Neither A, B, nor C made any basic research payments for their taxable year ending December 31, 2003. For purposes of computing the group credit for the 2003 taxable year (the credit year), A, B, and C had the following:

	A	B	C	Group Aggregate
Credit Year Qualified Research Expenses (QREs)	$200x	$20x	$110x	$330x
1984–1988 QREs	$40x	$10x	$100x	$150x
1984–1988 Gross Receipts	$1,000x	$350x	$150x	$1,500x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) *Computation of the group credit* — (*A*) *In general*. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($330x) over the group's base amount ($170x). The group credit is 0.20 × ($330x – $170x), which equals $32x.

(B) *Group's base amount* — (*1*) *Computation*. The group's base amount equals the greater of: the group's fixed-base percentage (10 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,700x), or the group's minimum base amount ($165x). The group's base amount, therefore, is $170x, which is the greater of: 0.10 × $1,700x, which equals $170x, or $165x.

(*2*) *Group's minimum base amount*. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $330x, which equals $165x.

(*3*) *Group's fixed-base percentage*. The group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bears to the group's aggregate gross receipts for the same period, or 16 percent (the statutory minimum). The group's fixed-base percentage, therefore, is 10 percent, which is the lesser of: $150x/$1,500x, which equals 10 percent, or 16 percent.

(iii) *Allocation of the group credit*. The group credit of $32x is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the controlled group. The $32x group credit is allocated as follows:

	A	B	C	Total
Stand-Alone Entity Credit	$20x	$2x	$11x	$33x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/33	2/33	11/33	
Multiplied by: Group Credit	$32x	$32x	$32x	
Equals: Credit Allocated to Member	$19.39x	$1.94x	$10.67x	$32x

Example 2. Member is a start-up company — (i) *Facts*. D, E, and F, all of which are calendar-year taxpayers, are members of a controlled group of corporations. F is a start-up company under section 41(c)(3)(B)(i). D and E are not start-up companies under section 41(c)(3)(B)(i). Neither D, E, nor F made any basic research payments during the 2003 taxable year. For purposes of computing the group credit for the 2003 taxable year (the credit year), D, E, and F had the following:

	D	E	F	Group Aggregate
Credit Year QREs	$200x	$20x	$50x	$270x
1984–1988 QREs	$55x	$15x	$0x	$70x
1984–1988 Gross Receipts	$1,000x	$400x	$0x	$1,400x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$0x	$1,400x

(ii) *Computation of the group credit* — (A) *In general*. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($270x) over the group's base amount ($135x). The group credit is 0.20 × ($270x – $135x), which equals $27x.

(B) *Group's base amount* — (*1*) *Computation*. The group's base amount equals the greater of: the group's fixed-base percentage (5 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($1,400x), or the group's minimum base amount ($135x). The group's base amount, therefore, is $135x, which is the greater of: 0.05 × $1,400x, which equals $70x, or $135x.

(*2*) *Group's minimum base amount*. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $270x, which equals $135x.

(*3*) *Group's fixed-base percentage*. Because only one member of the group, F, is a start-up company under section 41(c)(3)(B)(i), the group is not a start-up company under paragraph (b)(2) of this section. Therefore, the group's fixed-base percentage is the lesser of: the ratio that the group's aggregate QREs for the taxable years beginning after December 31, 1983, and before January 1, 1989, bears to the group's aggregate gross receipts for the same period, or 16 percent (the statutory minimum). The group's fixed-base percentage, therefore, is 5 percent, which is the lesser of: $70x/$1,400x, which equals 5 percent, or 16 percent.

(iii) *Allocation of the group credit*. The group credit of $27x is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of stand-alone entity credits of all the members of the controlled group. The $27x group credit is allocated as follows:

	D	E	F	Total
Stand-Alone Entity Credit	$20x	$2x	$5x	$27x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	20/27	2/27	5/27	
Multiplied by: Group Credit	$27x	$27x	$27x	
Equals: Credit Allocated to Member	$20x	$2x	$5x	$27x

Example 3. *Group is a start-up company* — (i) *Facts*. G, H, and I, all of which are calendar-year taxpayers, are members of a controlled group of corporations. Each of G, H, and I qualifies as a start-up company under section 41(c)(3)(B)(i). The 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which each of G, H, and I has QREs. Because each of G, H, and I qualifies as a start-up company under section 41(c)(3)(B)(i), the group is treated as a start-up company under paragraph (b)(2) of this section. The 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which the group has QREs. Neither G, H, nor I made any basic research payments during the 2003 taxable year. For purposes of computing the group credit for the 2003 taxable year (the credit year), G, H, and I had the following:

	G	H	I	Group Aggregate
Credit Year QREs	$225x	$25x	$100x	$380x
1984–1988 QREs	$0x	$0x	$0x	$0x
1984–1988 Gross Receipts	$0x	$0x	$0x	$0x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,600x	$340x	$300x	2,240x

(ii) *Computation of the group credit* — (A) *In general*. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to 20 percent of the excess of the group's aggregate credit year QREs ($380x) over the group's base amount ($190x). The group credit is 0.20 × ($380x – $190x), which equals $38x.

(B) *Group's base amount* — (*1*) *Computation*. The group's base amount equals the greater of: the group's fixed-base percentage (3 percent) multiplied by the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year ($2,240x), or the group's minimum base amount ($190x). The group's base amount, therefore, is $190x, which is the greater of: 0.03 x $2,240x, which equals $67.2x, or $190x.

(*2*) *Group's minimum base amount*. The group's minimum base amount is 50 percent of the group's aggregate credit year QREs. The group's minimum base amount is 0.50 × $380x, which equals $190x.

(*3*) *Group's fixed-base percentage*. Each member of the group is a start-up company under section 41(c)(3)(B)(i), therefore, the group is a start-up company under paragraph (b)(2) of this section. Because the 2003 taxable year is the fifth taxable year beginning after December 31, 1993, for which the group has QREs, under section 41(c)(3)(B)(ii)(I), the group's fixed-base percentage is 3 percent.

(iii) *Allocation of the group credit*. The group credit of $38x is allocated among the members of the group based on the ratio that each member's stand-alone entity credit bears to the sum of stand-alone entity credits of all the members of the controlled group. The $38x group credit is allocated as follows:

	G	H	I	Total
Stand-Alone Entity Credit	$25.5x	$2.5x	$10x	$38x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	25.5/38	2.5/38	10/38	
Multiplied by: Group Credit	$38x	$38x	$38x	
Equals: Credit Allocated to Member	$25.5x	$2.5x	$10x	$38x

Example 4. Group alternative incremental research credit — (i) *Facts*. J, K, and L, all of which are calendar-year taxpayers, are members of a controlled group of corporations. The research credit under section 41(a) is not allowable to the group for the 2003 taxable year because the group's aggregate QREs for the 2003 taxable year are less than the group's base amount. The group credit is computed using the AIRC rules of section 41(c)(4). For purposes of computing the group credit for the 2003 taxable year (the credit year), J, K, and L had the following:

	J	K	L	Group Aggregate
Credit Year QREs	$0x	$20x	$110x	$130x
Average Annual Gross Receipts for 4 Years Preceding the Credit Year	$1,200x	$200x	$300x	$1,700x

(ii) *Computation of the group credit*. The research credit allowable to the group is computed as if the three corporations were one taxpayer. The group credit is equal to the sum of: 2.65 percent of so much of the group's aggregate QREs for the taxable year as exceeds 1 percent of the group's aggregate average annual gross receipts for the 4 taxable years preceding the credit year, but does not exceed 1.5 percent of such average; 3.2 percent of so much of the group's aggregate QREs as exceeds 1.5 percent of such average but does not exceed 2 percent of such average; and 3.75 percent of so much of such QREs as exceeds 2 percent of such average. The group credit is [0.0265 × [($1,700x × 0.015) – ($1,700x × 0.01)]] + [0.032 × [($1,700x × 0.02) – ($1,700x × 0.015)]] + [0.0375 × [$130x – ($1,700x × 0.02)]], which equals $4.10x.

(iii) *Allocation of the group credit*. The group credit is allocated to each member of the group by multiplying the group credit by the ratio that each member's stand-alone entity credit bears to the sum of the stand-alone entity credits of all the members of the group. The $4.10x group credit is allocated as follows:

	J	K	L	Total
Stand-Alone Entity Credit	$0x	$.66x	$3.99x	$4.65x
Allocation Ratio (Stand-Alone Entity Credit/Sum of Stand-Alone Entity Credits)	0/4.65	0.66/4.65	3.99/4.65	
Multiplied by: Group Credit	$4.10x	$4.10x	$4.10x	
Equals: Credit Allocated to Member	$0x	$.58x	$3.52x	$4.10x

(e) *For taxable years beginning before January 1, 1990*. For taxable years beginning before January 1, 1990, see §1.41–6 as contained in 26 CFR part 1, revised April 1, 2003.

(f) *Tax accounting periods used* — (1) *In general*. The credit allowable to a member of a controlled group of corporations or a group of trades or businesses under common control is that member's share of the group credit computed as of the end of that member's taxable year. In computing the group credit for a group whose members have different taxable years, a member generally should treat the taxable year of another member that ends with or within the credit year of the computing member as the credit year of that other member. For example, M, N, and O are members of a controlled group of corporations. M and N file a calendar year consolidated return. O files a separate return using a fiscal year ending June 30. For purposes of computing the group credit at the end of the M's and N's (the computing members') calendar year on December 31, O's fiscal year ending June 30, which ends within the M's and N's calendar year, is treated as O's credit year.

* * * * *

(i) *Effective date*. Paragraphs (a)(1), (a)(4), (b), (c), (d), and (f)(1) of this section 1.41–6 are applicable for taxable years beginning on or after the date these regulations are published in the **Federal Register** as final regulations. Generally, a taxpayer may use any reasonable method of computing and allocating the credit for taxable years beginning before the date these regulations are published in the **Federal Register** as final regulations. However, paragraph (b) relating to the computation of the group credit and paragraph (c), relating to the allocation of the group credit, will apply to taxable years ending on or after December 29, 1999, if the members of a controlled group, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b). In the case of a controlled group whose members have different taxable years and whose members use inconsistent methods of allocation, the members of the controlled group shall be deemed to have, as a whole, claimed more than 100 percent of the amount that would be allowable under paragraph (b).

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 28, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 29, 2003, 68 F.R. 44499)

Notice of Proposed Rulemaking and Notice of Public Hearing

Real Estate Mortgage Investment Conduits; Application of Section 446 With Respect to Inducement Fees

REG–162625–02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations relating to the proper timing and source of income from fees received to induce the acquisition of noneconomic residual interests in Real Estate Mortgage Investment Conduits (REMICs). The proposed regulations would apply to taxpayers who receive inducement fees in connection with becoming the holder of a noneconomic REMIC residual interest. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments must be received by October 20, 2003. Outlines of topics to be discussed at the public hearing scheduled for November 18, 2003, at 10:00 a.m. must be received by October 28, 2003.

ADDRESSES: Send submissions to CC:PA:RU (REG–162625–02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:RU (REG–162625–02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit electronic comments via the IRS Internet site at: *www.irs.gov/regs*. The public hearing will be held in the IRS Auditorium, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John W. Rogers III at (202) 622–3950; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett, at (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) under sections 446(b) (relating to general rules for methods of accounting), 860C (relating to other definitions and special rules applicable to REMICs), and 863(a) (relating to special rules for determining source) of the Internal Revenue Code of 1986 (Code). The proposed regulations prescribe certain accounting rules for taking an inducement fee into income over a period that is related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations set forth two safe harbor methods of accounting for inducement fees. The proposed regulations also contain a rule clarifying that an inducement fee is income from sources within the United States.

Explanation of Provisions

Final regulations governing REMICs, issued in 1992, contain rules governing the transfer of noneconomic residual interests. Those regulations do not, however, contain rules that address the transferee's treatment of the fee received to induce the acquisition of a REMIC noneconomic residual interest.

An inducement fee is paid to a transferee of a noneconomic residual interest because, under sections 860C(a)(1) and 860E(a)(1) of the Code, the holder of a REMIC residual interest must take into account the REMIC's taxable income or net loss. The holder of a noneconomic residual interest will receive insufficient distributions to cover the resulting tax liabilities, and a transferee will, therefore, require an inducement fee to become the holder of the noneconomic residual interest.

In its earlier years, a REMIC typically accrues more taxable interest income than deductible interest expense. As a result, in its earliest years, the REMIC will have net income (generally referred to as phantom income) taxable to the residual holder. This phenomenon generally will reverse, resulting in REMIC net loss (phantom loss) in later years.

Following release of the final REMIC regulations, the IRS and the Treasury Department received requests for guidance on the proper method of accounting to be used by taxpayers for inducement fee income. The proposed regulations provide rules relating to the proper timing and source of income from an inducement fee received in connection with becoming the holder of a noneconomic residual interest in a REMIC.

The proposed regulations provide that, to clearly reflect income, an inducement fee must be included in income over a period that is reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest. The proposed regulations provide that an inducement fee generally may not be taken into account in a single tax year.

The proposed regulations set forth two safe harbor methods of accounting for inducement fees. These safe harbor methods are:

(1) A book method, under which an inducement fee is recognized for federal income tax purposes in the same amounts and over the same period in which that inducement fee is included in income by the taxpayer for financial reporting purposes, provided that the period is not shorter than the period over which the applicable REMIC is expected to generate taxable income; and

(2) A method under which the inducement fee is recognized for federal income tax purposes ratably over the remaining anticipated weighted average life of the REMIC determined as of the time the noneconomic residual interest is transferred to the taxpayer. This method is based on rules in the final REMIC regulations for taking into account a REMIC sponsor's unrecognized gain or loss on a REMIC residual interest upon the formation of a REMIC.

Additionally, the proposed regulations contain a rule that applies if a holder of a residual interest sells or otherwise disposes of the residual interest. Under this rule, the holder must take into account, at the time of the sale or other disposition, any unrecognized portion of the inducement fee for that residual interest. Transactions to which section 381(c)(4) applies are excluded from this rule because section 381 and the regulations thereunder provide for the carryover of tax attributes, including methods of accounting. The IRS and the Treasury Department considered excluding other non-recognition transactions, such as contributions under sections 351 or 721. These other transactions, however, do not provide for the carryover of tax attributes. The proposed regulations, therefore, do not permit continued deferral of the unrecognized portion of an inducement fee following these other transactions.

The proposed regulations also contain a rule clarifying that an inducement fee is income from sources within the United States.

The IRS and the Treasury Department request comments on other possible safe harbor methods of accounting for these inducement fees. In particular, comments are requested on whether a safe harbor method that recognizes inducement fees proportionally to the anticipated future financing costs for funding the net tax liabilities of the noneconomic residual interest would be of general use to taxpayers and, if so, what factors should be used under that safe harbor method for determining a taxpayer's anticipated future financing costs.

The proposed regulations state that the treatment of inducement fees is a method of accounting that must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests. Thus, if a taxpayer uses a safe harbor method, the taxpayer must use that same safe harbor method for all inducement fees received in connection with any noneconomic REMIC residual interests held by the taxpayer.

The proposed regulations regarding the timing for inclusion of inducement fees in income, if finalized as proposed, would apply for taxable years ending on or after publication of the final regulations in the **Federal Register**. The IRS and the Treasury Department request comments with respect to whether the applicability of the regulations should be limited to transactions arising on or after the effective date of these regulations and whether some delay in the effective date of these regulations is warranted.

The proposed regulations clarifying the source of inducement fees, if finalized as proposed, would apply for taxable years ending on or after publication of the final regulations in the **Federal Register**.

A taxpayer may not change its method of accounting for inducement fees without securing the prior consent of the Commissioner. The Commissioner may prescribe terms and conditions necessary to obtain the Commissioner's consent to effect a change in method of accounting and to prevent amounts from being duplicated or omitted. See sections 446 and 481; §1.446–1(e)(3). The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or with an adjustment under section 481(a). The IRS and the Treasury Department request comments on how best to effect any change in method of accounting necessitated by these regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and the Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. The IRS and the Treasury Department also specifically request comments on the safe harbor methods provided in the regulations and suggestions for other possible safe harbor methods of accounting for these inducement fees. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 18, 2003, beginning at 10:00 a.m. in the IRS Auditorium, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 28, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are John W. Rogers III, Office of Associate Chief Counsel (Financial Institutions & Products), and Courtney L. Shepardson, Office of Division Counsel (Large and Midsize Business). However, other personnel from the IRS and the Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.446–6 also issued under 26 U.S.C 446 and 26 U.S.C. 860G * * *

Par. 2. Section 1.446–6 is added to read as follows:

§1.446–6 REMIC inducement fees.

(a) *Purpose*. This section provides specific timing rules for the clear reflection of income from an inducement fee received in connection with becoming the holder of a noneconomic REMIC residual interest. An inducement fee must be included in income over a period reasonably related to the period during which the applicable REMIC is expected to generate taxable income or net loss allocable to the holder of the noneconomic residual interest.

(b) *Definitions*. For purposes of this section—(1) *Applicable REMIC*. The applicable REMIC is the REMIC that issued the noneconomic residual interest with respect to which the inducement fee is paid.

(2) *Inducement fee*. An inducement fee is the amount paid to induce a person to become the holder of a noneconomic residual interest in an applicable REMIC.

(3) *Noneconomic residual interest*. A REMIC residual interest is a noneconomic residual interest if it is a noneconomic residual interest within the meaning of §1.860E–1(c)(2).

(4) *Remaining anticipated weighted average life*. The remaining anticipated weighted average life is the anticipated weighted average life determined using the methodology set forth in §1.860E–1(a)(3)(iv) applied as of the date of acquisition of the noneconomic residual interest.

(5) *REMIC*. The term REMIC has the same meaning in this section as given in §1.860D–1.

(c) *General rule*. All taxpayers, regardless of their overall method of accounting, must recognize an inducement fee over the remaining expected life of the applicable REMIC in a manner that reasonably reflects, without regard to this paragraph, the after-tax costs and benefits of holding that noneconomic residual interest.

(d) *Special rule on disposition of a residual interest*. If any portion of an inducement fee received with respect to the acquisition of a noneconomic residual interest in an applicable REMIC has not been recognized in full by the holder as of the time the holder sells, or otherwise disposes of, that residual interest in the applicable REMIC (in a transaction other than a transaction to which section 381(c)(4) applies), then the holder must include the unrecognized portion of the inducement fee in income at that time.

(e) *Safe harbors*. If inducement fees are recognized in accordance with a method described in this paragraph (e), that method complies with the requirements of paragraph (c) of this section.

(1) *The book method*. Under the book method, an inducement fee is recognized in accordance with the method of accounting, and over the same period, that is used by the taxpayer for financial reporting purposes (including consolidated financial statements to shareholders, partners, beneficiaries, other proprietors and for credit purposes), provided that the inducement fee is included in income for financial reporting purposes over a period that is not shorter than the period during which the applicable REMIC is expected to generate taxable income.

(2) *The modified REMIC regulatory method*. Under the modified REMIC regulatory method, the inducement fee is recognized ratably over the remaining anticipated weighted average life of the applicable REMIC as if the inducement fee were unrecognized gain being included in gross income under §1.860F–2(b)(4)(iii).

(3) *Additional safe harbor methods*. The Commissioner, by revenue ruling or revenue procedure published in the Internal Revenue Bulletin, may provide additional safe harbor methods for recognizing inducement fees on noneconomic REMIC residual interests.

(f) *Method of accounting*. The treatment of inducement fees is a method of accounting to which the provisions of sections 446 and 481 and the regulations thereunder apply. A taxpayer is generally permitted to adopt a method of accounting for inducement fees that satisfies the requirements of paragraph (c) of this section. Once a taxpayer adopts a method of accounting for inducement fees, that method must be applied consistently to all inducement fees received in connection with noneconomic REMIC residual interests and may be changed only with the consent of the Commissioner, as provided by section 446(e) and the regulations and procedures thereunder.

(g) *Effective date*. This section is applicable for taxable years ending on or after the date this document is published as a final regulation in the **Federal Register**.

Par. 3. Section 1.860A–0 is amended by adding an entry in the outline for §1.860C–1(d) to read as follows:

§1.860A–0 Outline of REMIC provisions.

* * * * *

§1.860C–1 Taxation of holders of residual interests.

* * * * *

(d) Treatment of REMIC inducement fees.

* * * * *

Par. 4. Section 1.860C–1 is amended by adding paragraph (d) to read as follows:

§1.860C–1 Taxation of holders of residual interests.

* * * * *

(d) For rules on the proper accounting for income from inducement fees, see §1.446–6.

Par. 5. Section 1.863–0 is amended by:

1. Adding an entry for §1.863–1(d).
2. Redesignating the entry for §1.863–1(e) as §1.863–1(f)
3. Adding a new entry for §1.863–1(e).

The additions read as follows:

§1.863–0 Table of contents.

* * * * *

§1.863–1 Allocation of gross income.

* * * * *

(d) Scholarships, fellowship grants, grants, prizes and awards.

(e) REMIC inducement fees.

* * * * *

Par. 6. Section 1.863–1 is amended as follows:

1. Paragraph (e) is revised.
2. Paragraph (f) is added.

The revision and addition reads as follows:

§1.863–1 Allocation of gross income.

* * * * *

(e) *REMIC inducement fees*. An inducement fee (as defined in §1.446–6(b)(2)) shall be treated as income from sources within the United States.

(f) *Effective dates*. The rules of paragraphs (a), (b) and (c) of this section will apply to taxable years beginning after December 30, 1996. However, taxpayers may apply the rules of paragraphs (a), (b) and (c) of this section for taxable years beginning after July 11, 1995, and on or before December 30, 1996. For years beginning before December 30, 1996, see §1.863–1 (as contained in 26 CFR part 1 revised as of April 1, 1996). See paragraph (d)(4) of this section for rules regarding the applicability date of paragraph (d) of this section. Paragraph (e) of this section is applicable for taxable years ending on or after the date this document is published as a final regulation in the **Federal Register**.

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 18, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 21, 2003, 68 F.R. 43055)

Notice of Proposed Rulemaking

Elimination of Forms of Distribution in Defined Contribution Plans

REG–112039–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations that would modify the circumstances under which certain forms of distribution previously available are permitted to be eliminated from qualified defined contribution plans. These proposed regulations affect qualified retirement plan sponsors, administrators, and participants.

DATES: Written and electronic comments and request for a public hearing must be received by October 6, 2003.

ADDRESSES: Send submissions to: CC:PA:RU (REG–112039–03), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:RU (REG–112039–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Vernon S. Carter, 202–622–6060 (not a toll-free number); concerning submissions or hearing requests, Guy Traynor, 202–622–7180 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Explanation of Provisions

This document contains proposed amendments to 26 CFR part 1 under section 411(d)(6) of the Internal Revenue Code of 1986 (Code) as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) (115 Stat. 117). Section 411(d)(6)(A) of the Code generally provides that a plan will not be treated as satisfying the requirements of section 411 if the accrued benefit of a participant is decreased by a plan amendment. Section 411(d)(6)(B) prior to amendment by EGTRRA provided that an amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either eliminating or reducing an early retirement benefit or a retirement-type subsidy, or, except as provided by regulations, eliminating an optional form of benefit.

The IRS published T.D. 8900, 2000–2 C.B. 279 [65 FR 53901], in the **Federal Register** on September 6, 2000. T.D. 8900, which amended section §1.411(d)–4 of the Income Tax Regulations, added paragraph (e) of Q&A–2 to provide for additional circumstances under which a defined contribution plan can be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under certain optional forms of benefit.

Section 1.411(d)–4, Q&A–2(e)(1) provides that a defined contribution plan may be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under a particular optional form of benefit without violating the section 411(d)(6) anti-cutback rules if, once the plan amendment takes effect for a participant, the alternative forms of payment that remain available to the participant include payment in a single-sum distribution form that is "otherwise identical" to the eliminated or restricted optional form of benefit. The amendment cannot apply to a participant for any distribution with an annuity starting date before the earlier of the 90th day after the participant receives a summary that reflects the plan amendment and that satisfies Department of Labor's requirements for a summary of material modifications under 29 CFR 2520.104b–3, or the first day of the second plan year following the plan year in which the amendment is adopted. Section §1.411(d)–4, Q&A–2(e)(2) provides that a single-sum distribution form is "otherwise identical" to the optional form of benefit that is being eliminated or restricted only if it is identical in all respects (or would be identical except that it provides greater rights to the participant), except for the timing of payments after commencement. A single-sum distribution form is not "otherwise identical" to a specified installment form of benefit if the single-sum form:

- is not available for distribution on any date on which the installment form could have commenced;
- is not available in the same medium as the installment form; or
- imposes any additional condition of eligibility.

Further, an otherwise identical distribution form need not retain any rights or features of the eliminated or restricted optional form of benefit to the extent those rights or features would not be protected from elimination under the anti-cutback rules. The single-sum distribution form would not, however, be disqualified from being an otherwise identical distribution form if the single-sum form provides greater rights to participants than did the eliminated or restricted optional form of benefits.

Section 645(a)(1) of EGTRRA revised section 411(d)(6) in a manner that is similar to §1.411(d)–4, Q&A–2(e), but without the advance notice condition. Section 411(d)(6)(E) of the Code provides that, except to the extent provided in regulations, a defined contribution plan is not treated as reducing a participant's accrued benefit where a plan amendment eliminates a form of distribution previously available under the plan if a single-sum distribution is available to the participant at the same time as the form of distribution eliminated by the amendment, and the single-sum distribution is based on the same or greater portion of the participant's account as the form of distribution eliminated by the amendment.

To reflect the addition of section 411(d)(6)(E) by EGTRRA, these proposed regulations would amend §1.411(d)–4, Q&A–2(e). Under these amendments, the regulations would retain the rules under which a defined contribution plan may be amended to eliminate or restrict a participant's right to receive payment of accrued benefits under a particular optional form of benefit without violating the section 411(d)(6) anti-cutback rules if, once the plan amendment takes effect for a participant, the alternative forms of payment that remain available to the participant include payment in a single-sum distribution. However, these proposed regulations would remove the 90-day notice condition previously applicable to these plan amendments.[1]

Under section 101 of Reorganization Plan No. 4 of 1978 (43 FR 47713), the Secretary of the Treasury has interpretive jurisdiction over the subject matter addressed in these regulations for purposes of the Employee Retirement Income Security Act of 1974 (ERISA), as well as the Code. Section 204(g)(2) of ERISA, as amended by EGTRRA, provides a parallel rule to section 411(d)(6)(E) of the Code that applies under Title I of ERISA, and authorizes the Secretary of the Treasury to provide exception to this parallel ERISA requirement. Therefore, these regulations apply for purposes of the parallel requirements of sections 204(g)(2) of ERISA, as well as for section 411(d)(6)(E) of the Code.

Effective Date and Applicability Date

The proposed regulations are proposed to apply on the date of publication of final regulations in the **Federal Register**.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Vernon S. Carter of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

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Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

Paragraph 1. The authority citation for part 1 is amended to read in part as follows:

Authority: 26 U.S.C. 7805***

Section 1.411(d)–4, Q&A–2(e) also issued under 26 U.S.C. 411(d)(6)(E). * * *

Par. 2. Section 1.411(d)–4, Q&A–2(e) is revised to read as follows:

§1.411(d)–4 Section 411(d)(6) protected benefits.

* * * * *

A–2: * * *

(e) *Permitted plan amendments affecting alternative forms of payment under defined contribution plans*—(1) *General rule*. A defined contribution plan does not violate the requirements of section 411(d)(6) merely because the plan is amended to eliminate or restrict the ability of a participant to receive payment of accrued benefits under a particular optional form of benefit if, after the plan amendment is effective with respect to the participant, the alternative forms of payment available to the participant include payment in a single-sum distribution form that is otherwise identical to the optional form of benefit that is being eliminated or restricted.

(2) *Otherwise identical single-sum distribution*. For purposes of this paragraph (e), a single-sum distribution form is otherwise identical to an optional form of benefit that is eliminated or restricted pursuant to paragraph (e)(1) of this Q&A–2 only if the single-sum distribution form is identical in all respects to the eliminated or restricted optional form of benefit (or would be identical except that it provides greater rights to the participant) except with respect to the timing of payments after commencement. For example, a single-sum distribution form is not otherwise identical to a specified installment form of benefit if the single-sum distribution form is not available for distribution on the date on which the installment form would have been available for commencement, is not available in the same medium of distribution as the installment form, or imposes any condition of eligibility that did not apply to the installment form. However, an otherwise identical distribution form need not retain rights or features of the optional form of benefit that is eliminated or restricted to the extent that those rights or features would not be protected from elimination or restriction under section 411(d)(6) or this section.

(3) *Example*. The following example illustrates the application of this paragraph (e):

Example. (i) P is a participant in Plan M, a qualified profit-sharing plan with a calendar plan year that is invested in mutual funds. The distribution forms available to P under Plan M include a distribution of P's vested account balance under Plan M in the form of distribution of various annuity contract forms (including a single life annuity and a joint and survivor annuity). The annuity payments under the annuity contract forms begin as of the first day of the month following P's severance from employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)). P has not previously elected payment of benefits in the form of a life annuity, and Plan M is not a direct or indirect transferee of any plan that is a defined benefit plan or a defined contribution plan that is subject to section 412. Distributions on the death of a participant are made in accordance with plan provisions that comply with section 401(a)(11)(B)(iii)(I). On May 2, 2004, Plan M is amended so that, after the amendment is effective, P is no longer entitled to any distribution in the form of the distribution of an annuity contract.

[1] The Department of Labor has advised Treasury and the IRS that it should be noted that plans covered by Title I of ERISA will continue to be subject to the requirement under Title I that plan amendments be described in a timely summary of material modifications (SMM) or a revised summary plan description (SPD) to be distributed to plan participants and beneficiaries in accordance with applicable Department of Labor disclosure rules (see 29 CFR 2520.104b–3).

However, after the amendment is effective, P is entitled to receive a single-sum cash distribution of P's vested account balance under Plan M payable as of the first day of the month following P's severance from employment (or as of the first day of any subsequent month, subject to the requirements of section 401(a)(9)). The amendment does not apply to P if P elects to have annuity payments begin before July 1, 2004.

(ii) Plan M does not violate the requirements of section 411(d)(6) (or section 401(a)(11)) merely because, as of July 1, 2004, the plan amendment has eliminated P's option to receive a distribution in any of the various annuity contract forms previously available.

(4) *Effective date*. This paragraph (e) is applicable on the date of publication of final regulations in the **Federal Register**.

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Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 7, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 8, 2003, 68 F.R. 40581)

Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

Prohibited Allocations of Securities in an S Corporation

REG–129709–03

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: In this issue of the Bulletin, the IRS is issuing temporary regulations (T.D. 9081) that provide guidance on identifying disqualified persons and determining whether a plan year is a nonallocation year under section 409(p) and on the definition of synthetic equity under section 409(p)(5). These proposed regulations would generally affect plan sponsors of, and participants in, ESOPs holding stock of Subchapter S corporations. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 17, 2003.

Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for November 17, 2003, at 10 a.m. must be received by October 27, 2003.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–129709–03), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:PA:LPD:PR (REG–129709–03), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at *www.irs.gov/regs*. The public hearing will be held in room 6718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, John Ricotta at 622–6060; concerning submissions of comments, Sonya Cruse, (202) 622–4693 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Temporary regulations (T.D. 9081) on page 420 of this issue of the Bulletin amend the Income Tax Regulations (26 CFR part 1) relating to section 409(p). The temporary regulations contain rules relating to the identification of disqualified persons and determination whether a plan year is a nonallocation year under section 409(p) and the definition of synthetic equity under section 409(p)(5). The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. Because §1.409(p)–1 imposes no new collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

Comments are requested with respect to issues raised by S corporation ESOPs established by March 14, 2001, that will need to comply with the requirements of section 409(p) beginning in 2005. For these ESOPs, the inclusion of deferred compensation as synthetic equity can be avoided by distributing such deferred compensation before 2005. Some employers may prefer other transition approaches. For example, a preferable transition approach may be to spin off and terminate the portion of a plan benefitting disqualified persons. Comments are requested on whether guidance is needed to address these possible transition approaches.

Comments are also requested on issues that are reserved in the regulations with respect to whether certain interests in an S corporation should be treated as synthetic equity, including the extent to which rights to acquire assets of the S corporation or another person are established for reasonable business purposes and should not be treated as synthetic equity. While comments can be filed as late as October 17, 2003, commentators are encouraged to file comments as early as possible because the IRS and Treasury intend to move forward to address these issues as early as 2003.

Commentators may also wish to comment on section 409(p)-related issues that are not directly raised in the proposed regulations. For example, commentators may wish to comment on the extent to which administrative guidance may be needed on an interim basis to deal with specific structures used to avoid or evade the purpose of section 409(p).

A public hearing has been scheduled for November 17, 2003, at 10 a.m. in room 6718 of the Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts at the Constitution Avenue entrance. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 27, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is John Ricotta of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and Treasury participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.409(p)–1 also issued under 26 U.S.C. 409(p)(7)(A). * * *

Par. 2. Section 1.409(p)–1 is added to read as follows:

§1.409(p)–1 Prohibited allocation of securities in an S corporation.

[The text of proposed §1.409(p)–1 is the same as the text of §1.409(p)–1T published elsewhere in this issue of the Bulletin].

Robert E. Wenzel,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on July 18, 2003, 8:45 a.m., and published in the issue of the Federal Register for July 21, 2003, 68 F.R. 43058)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
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Ann	Announcement
CD	Court Decision
DO	Delegation Order
EO	Executive Order
PL	Public Law
PTE	Prohibited Transaction Exemption
RP	Revenue Procedure
RR	Revenue Ruling
SPR	Statement of Procedural Rules
TC	Tax Convention
TD	Treasury Decision
TDO	Treasury Department Order

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