TAX MANAGEMENT
PORTFOLIOS™

U.S. Income

Section 401(k) Cash or Deferred Arrangements

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TAX MANAGEMENT PORTFOLIOS™

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Section 401(k) Cash or Deferred Arrangements

PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Section 401(k) Cash or Deferred Arrangements*, No. 358-5th, discusses qualified cash or deferred arrangements described in §401(k) of the Internal Revenue Code, including the fundamental tax-qualification requirements for what are commonly referred to as "401(k) plans."

Part I of this Portfolio provides a brief overview of qualified cash or deferred arrangements, their advantages, the statutory requirements that apply to them, and a discussion of the types of contributions that may be made to them. Part II includes a detailed analysis of the requirements for a qualified cash or deferred arrangement, including the types of tax-qualified plans that may include a qualified cash or deferred arrangement, what it means to make an election to defer compensation, general automatic contribution arrangements, permissible distribution events, nonforfeitability, special eligibility rules, the contingent benefit rule, and the types of employers that are eligible to offer a qualified cash or deferred arrangement. Part III discusses the special nondiscrimination rules that apply to qualified cash or deferred arrangements, including ADP testing for elective deferrals and ACP testing for matching contributions. Part IV discusses the special rules for design-based safe harbor plans, including §401(k)(12) safe harbor plans with matching or non-elective contributions, §401(k)(13) safe harbor plans with qualified automatic contribution arrangements, combined eligible DB(k) plans, and SIMPLE 401(k) plans. Part V focuses on Roth contributions. Part VI addresses eligible automatic contribution arrangements under §414(w). Part VII discusses the §402(g) annual limit on elective deferrals and Part VIII discusses §414(v) catch-up contributions. Part IX discusses cash or deferred arrangements that do not satisfy the requirements of §401(k) (i.e., nonqualified cash or deferred arrangements). Part X traces the history of cash or deferred arrangements and the evolution of the rules that apply to them.

The Worksheets of this Portfolio contain a sample profit-sharing plan that includes a qualified cash or deferred arrangement, an eligible automatic contribution arrangement, and designated Roth contributions.

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Tax Management portfolios on related topics include:

- 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*;
- 353 T.M., *Employee Benefit Plans and Issues for Small Employers*;
- 360 T.M., *Qualified Plans — IRS Determination Letter Procedures*;
- 361 T.M., *Reporting and Disclosure Under ERISA*;
- 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*; and
- 371 T.M., *Employee Plans — Deductions, Contributions, and Funding*.

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DETAILED ANALYSIS

I. Introduction

A. Section 401(k) and the General Description of a CODA

Section 401(k)[1] provides the statutory basis for employees to contribute a portion of their cash compensation to certain types of tax-qualified retirement plans on a pre-tax basis.

A qualified cash or deferred arrangement (CODA) is the mechanism by which §401(k) permits such pre-tax elective contributions to be made to a plan. Specifically, §401(k) describes a CODA as any arrangement that is part of a qualified profit-sharing or stock bonus plan under which an eligible employee may elect to have the employer make payments as contributions to a trust under the plan, on behalf of the employee, or to the employee directly in cash.[2] In addition to providing the basic definition of a CODA, §401(k) sets forth the various requirements that a CODA must satisfy to be a "qualified CODA."

Arrangements that permit employees to make pre-tax elective contributions are often referred to as "401(k) plans." However, this term is misleading, because a 401(k) plan is really a §401(a) profit-sharing plan (or other type of eligible plan) which contains a qualified CODA feature described in §401(k).

Because a CODA is part of a tax-qualified plan, contributions other than pre-tax elective deferrals also may be made to the plan by either the employer or the employee. These contributions include employer profit-sharing contributions, employer matching contributions, employee after-tax contributions, qualified nonelective employer contributions, and Roth contributions. Although certain types of contributions are not made through the CODA, they can impact whether the CODA is a qualified CODA within the meaning of §401(k), which gives rise to the complex rules that apply to 401(k) plans. In addition, different vesting, distribution, and nondiscrimination tests apply to contributions made through a CODA, rather than to contributions made outside of the CODA, which makes it important for the plan to properly describe the conditions under which the various types of contributions are made and to do so in a manner that satisfies the requirements for a qualified CODA.

A CODA may be designed so that the employee must make an affirmative election to have contributions made to the plan and will otherwise receive the full amount of his or her cash compensation if no election is made. Alternatively, a plan may provide that a specified portion of the employee's cash compensation will be contributed to the plan unless the employee elects not to make contributions (and to receive the full amount of his or her cash compensation in lieu of such contributions) or elects to make contributions at a different rate. These CODAs are sometimes referred to as "automatic contribution arrangements" and are subject to additional rules under §401(k).

B. Federal Tax Advantages of Elective Contributions Under a Qualified CODA

Several significant tax benefits result from contributing to a qualified CODA under §401(k). Perhaps most importantly, a qualified CODA is the exclusive means by which employees can defer the receipt of compensation and contribute it to a tax-qualified retirement plan on a pre-tax basis. Under basic income tax principles, an amount is generally includible in an employee's gross income for the tax year in which the employee actually or constructively receives the amount. However, §402(e)(3) is the exception to this rule, providing that amounts contributed to a trust under a qualified CODA are not treated as distributed or made available to the employee (i.e., they are not currently includible in gross income), nor as contributions made to the trust by the employee rather than the employer (i.e., they are treated as employer contributions rather than as after-tax employee contributions) merely because the employee can elect whether the contribution will be made to the trust or received in cash. More specifically, the regulations under §401(k) provide that elective contributions under a qualified CODA 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 deferrals are contributed to the plan.[3] Thus, unless an employee's elective contributions are made pursuant to a qualified CODA, they will be includible in the employee's gross income in the tax year that the contributions were made to the plan, rather than in the tax year they are distributed from the plan.[4] Moreover, these elective contributions (and the related earnings) can be paid as an eligible rollover distribution from the plan and be rolled over on a tax-deferred basis to an individual retirement account or annuity or to another tax-qualified plan.[5]

Alternatively, a qualified CODA may allow an employee to designate some or all elective contributions as designated Roth contributions, which is another type of plan design feature that is only available through a qualified CODA. Designated Roth contributions are elective contributions under a CODA that, unlike pre-tax elective contributions, are subject to federal income tax at the time they are deducted from employee compensation.[6] The investment gain attributable to designated Roth contributions, like gain on pre-tax contributions, accumulates on a tax-free basis.[7] However, in contrast to pre-tax elective contributions, a qualified distribution of an amount attributable to designated Roth contributions, and the related investment

[1] All section references herein are to the Internal Revenue Code, as amended, and the regulations thereunder, unless otherwise stated.

[2] §401(k)(2)(A).

[3] Reg. §1.401(k)-1(a)(4)(iii).

[4] Reg. §1.401(k)-1(a)(3)(vi).

[5] §402(c).

[6] §402A(a).

[7] §501(a).

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earnings, are not subject to federal income tax.[8] This is comparable to the tax treatment of a Roth IRA.[9] In addition, any payment or distribution from a designated Roth account may be rolled over on a tax-deferred basis to a Roth IRA or another tax-favored plan with a Roth feature.[10]

Another significant benefit of a qualified CODA is that the investment gains on elective contributions made under a qualified CODA (other than designated Roth contributions) are not subject to federal income tax until they are distributed from the plan, usually after retirement when the employee may be in a lower tax bracket. In addition, the trust will not be subject to federal income tax on the investment return attributable to the contributions.[11] As discussed above, investment earnings attributable to Roth contributions can be excluded entirely from federal income tax if made as "qualifying distributions."

A qualified CODA is also unique in that it is the only type of feature that allows for employer matching contributions to be made to a tax-qualified plan. Employer matching contributions are entirely contingent upon whether and to what extent an employee voluntarily elects to make contributions to a tax-qualified retirement plan on a pre-tax basis, and a qualified CODA, as discussed above, is the only means by which employees can make such elective deferrals of compensation. Thus, without a qualified CODA, an employer cannot make matching contributions which, by virtue of being directly related to the amount of employees' elective deferrals and subject to vesting, can serve both to incentivize employees to save for retirement and encourage employee retention.

Finally, a qualified CODA offers tax advantages to employers as well as employees. The amounts an employer contributes to a qualified CODA pursuant to an employee's election, as well as matching contributions, are currently deductible by the employer (subject to certain limitations), even though the employee or beneficiary may not pay federal income tax on the contributions until several years later, upon a distribution event.[12] In contrast, employers generally may not claim a federal income tax deduction for amounts that an employee elects to contribute to a nonqualified deferred compensation plan until the benefits are paid to the employee or beneficiary. Although employers can also claim a current deduction for other types of employer contributions, such as profit-sharing or nonelective employer contributions, a qualified CODA offers employers the ability to make additional, tax-deductible contributions in the form of employee elective deferrals and employer matching contributions.

Although §401(k) only addresses qualified CODA arrangements, the regulations under §401(k) permit the existence of nonqualified CODA arrangements, stating that a profit-sharing or stock bonus plan (or pre-ERISA money purchase pension or rural cooperative plan) will not fail to satisfy the requirements of §401(a) merely because the plan includes a *nonqualified* cash or deferred arrangement.[13] A nonqualified CODA is defined broadly to include any cash or deferred arrangement that does not satisfy the requirements in the regulations to be a qualified CODA.[14] However, elective contributions made under a nonqualified cash or deferred arrangement are includible in an employee's gross income at the time the employee would have received the cash or other taxable amount if the cash or deferred election had not been made.[15] In addition, a plan with a nonqualified CODA must satisfy the nondiscrimination test of §401(a)(4) without applying the special nondiscrimination test of §401(k)(3) (i.e., the actual deferral percentage (ADP) test),[16] and the plan must treat the elective deferrals as nonelective employer contributions.[17] Section 401(k) discrimination tests are discussed in III., below.

Amounts that an employee elects to have contributed to the trust are treated differently than other employer contributions for FICA tax purposes. Employer contributions to a qualified retirement plan are not considered "wages" subject to FICA taxes.[18] However, elective deferrals made pursuant to a qualified CODA, including both elective pre-tax contributions and designated Roth contributions, are "wages" subject to FICA taxes.[19] Amounts distributed from a CODA are not subject to FICA taxes, regardless of whether the distributions are attributable to elective contributions or an employer's nonelective contributions.[20]

C. Summary of the Statutory Requirements for a Qualified CODA

In order for the federal income tax advantages described above to apply to employee elective contributions and employer matching contributions made under a CODA, the CODA must constitute a "qualified" CODA as defined in §401(k)(2), §401(k)(3), §401(k)(4), and §414A (effective for plan years beginning on or after January 1, 2025).[21] A qualified CODA is an arrangement that satisfies all of the following general requirements:

- The CODA is part of a tax-qualified profit-sharing or stock bonus plan;[22]
- The CODA offers an employee election to contribute to a qualified trust;[23]
- Distributions of elective contributions from the CODA are restricted to permissible events;[24]
- The employee's right to benefits attributable to elective contributions made under the CODA are nonforfeitable;[25]

[8] §402A(d)(1).
[9] §408A(d).
[10] §402A(c)(3).
[11] §501(a).
[12] §404.
[13] Reg. §1.401(k)-1(a)(5)(iv)(A).
[14] Reg. §1.401(k)-1(a)(5)(i).
[15] Reg. §1.401(k)-1(a)(5)(iii).
[16] Reg. §1.401(k)-1(a)(5)(iv)(A).
[17] Reg. §1.401(k)-1(a)(5)(ii).
[18] §3121(a)(5)(A).
[19] §3121(v)(1)(A).
[20] §3121(a)(5)(A).
[21] *See* Reg. §1.401(k)-1(a)(4)(iii), §1.402(a)-1(d)(2). Section 414A was added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §101(a), and is effective for plan years beginning on or after January 1, 2025. *See also* Prop. Reg. §1.414A–1, REG-100669-24, 90 Fed. Reg. 3092 (Jan. 14, 2025) (automatic enrollment requirements under §414A).
[22] §401(k)(2) (introductory language).
[23] §401(k)(2)(A).
[24] §401(k)(2)(B).
[25] §401(k)(2)(C).

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- The years of service requirement for participation does not exceed established limits;[26]
- Amounts attributable to elective contributions under the CODA satisfy the special ADP nondiscrimination test (or the plan is designed to be a "safe harbor plan");[27]
- No benefits may be contingent upon the election to defer;[28]
- The employer must be eligible to offer a CODA;[29]
- Elective deferrals cannot be used to help another plan satisfy tax-qualification requirements of §401(a) or the minimum coverage requirements of §410(b);[30]
- The CODA includes certain automatic enrollment and automatic contribution escalation features (effective for plan years beginning on or after January 1, 2025);[31] and
- The tax-qualified plan, together with the CODA, satisfies all other applicable §401(a) requirements,[32] including as discussed herein, the
  - o §401(a)(4) nondiscrimination requirements, one of which is that amounts attributable to matching contributions and after-tax contributions satisfy the special ACP nondiscrimination test (or satisfy the ACP safe harbor);[33]
  - o §402(g) limit on elective deferrals;[34]
  - o §415(c) contribution limits;[35]
  - o §401(a)(17) compensation limits;
  - o §416 top-heavy requirements;[36]
  - o §401(a)(28) diversification requirements for employee stock ownership plans; and
  - o §401(a)(35) diversification requirements for defined contributions plans with publicly traded employer securities.

Once these fundamental requirements have been satisfied to establish a qualified CODA, there are certain plan design alternatives for the CODA that are provided for in other parts of §401(k) and pursuant to other sections of the Code. These features include:

- §401(k)(12) safe harbor status (with matching or nonelective contributions);
- §401(k)(13) safe harbor status (with a qualified automatic contribution arrangement);
- §401(k)(16) starter §401(k) deferral-only plans;[37]
- §414(x) eligible combined defined benefit plans with a qualified CODA;
- §401(k)(11) SIMPLE plans;
- §402A treatment of elective deferrals as Roth contributions;
- §414(w) eligible automatic contribution arrangements; and
- §414(v) catch-up contributions.

Although these features are not required to be included as part of a qualified CODA, if the plan is designed to include any of them, the CODA must comply with the additional, applicable statutory requirements.

D. Types of Contributions

As noted above, a qualified CODA is an arrangement that "is part of" a qualified profit-sharing or stock bonus plan (or other eligible defined contribution pension plan).[38] Thus, elective plan contributions under the CODA need not be the only contributions under the plan. In fact, it is common for a plan with a qualified CODA to include employer nonelective contributions, matching contributions, and other types of contributions. This subsection describes some common types of contributions that can be made to a §401(k) plan.

1. Elective Contributions and Elective Deferrals

In the context of a qualified CODA, the terms "elective contribution" and "elective deferral" both refer to an employer contribution made at the election of the employee on a pretax basis, despite the fact that each of these terms is separately defined for different purposes under the Code and regulations. The specific definitions of each term, the purposes for which they are used, and the technical differences between them are discussed in detail below.

The term "elective contributions" is broadly defined in Reg. §1.401(k)-6 as employer contributions made to a plan pursuant to an election under a qualified or nonqualified CODA.[39] However, the definition of "elective contribution" is further refined in Reg. §1.401(k)-1 by reference to whether or not it is made under a qualified or a nonqualified CODA. In this regard, the regulations provide that elective contributions made under a qualified CODA, including Roth contributions, are not includible in an employee's income at the time that the cash would have been paid to the employee[40] and are treated as *"em-*

[26] §401(k)(2)(D).

[27] §401(k)(3) (ADP test); §401(k)(11), §401(k)(12), §401(k)(13), §414(x) (safe harbor plan options).

[28] §401(k)(4)(A).

[29] §401(k)(4)(B).

[30] §401(k)(4)(C).

[31] §414A, added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §101(a), effective for plan years beginning on or after January 1, 2025, for qualified CODAs established on or after December 29, 2022. *See* Prop. Reg. §1.414A–1(c).

[32] §401(k)(2) (introductory language); for the additional tax-qualification requirements of §401(a) that apply to all retirement plans, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*

[33] §401(k)(4)(A), requiring that matching and after-tax contributions satisfy the requirements of §401(m), which includes the ACP test, in order to be contributed to a CODA without violating the contingent benefit rule of §401(k)(4)(A); §401(m)(11) (ACP safe harbor).

[34] §401(a)(30).

[35] §401(a)(16).

[36] §401(a)(10).

[37] Added by Pub. L. No. 117-328, Div. T, §121(a), effective for plan years beginning on or after January 1, 2024.

[38] §401(k)(2).

[39] Reg. §1.401(k)-6.

[40] Reg. §1.401(k)-1(a)(4)(iii).

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ployer contributions.'[41] In contrast, the regulations provide that elective contributions made under a nonqualified CODA are includible in an employee's income at the time the cash would have been paid to the employee[42] and are treated as *"nonelective employer contributions."*[43] Thus, using the term elective contribution without specifying whether it was made under a qualified or nonqualified CODA technically could mean that the elective contribution includes either pre-tax employer contributions, after-tax employer contributions,[44] or both.

The term "elective deferral" is defined for purposes of the annual contribution limitation of §402(g) as any employer contribution under a *qualified* CODA that is not includible in gross income for the tax year, except that it includes designated Roth contributions, which are made on a post-tax basis (discussed in V., below).[45] Similarly, an elective contribution is defined, in part, to include employer contributions made under a qualified CODA that are not currently includible in gross income, as discussed above. Thus, where the context clearly indicates the existence of a qualified CODA, both elective contributions and elective deferrals have the same meaning — pre-tax employer contributions made at the election of the employee.

In other words, the only situation in which the terms elective deferral and elective contribution do not have the same meaning is in that of a nonqualified CODA. In this instance, the broader definition of elective contribution includes an after-tax employer contribution to the nonqualified CODA, while the narrower definition of elective deferral has no application to a nonqualified CODA. As the existence of a nonqualified CODA in a tax-qualified plan is rare, the terms elective contribution and elective deferral can normally be used interchangeably, despite their technical differences.

Elective contributions and elective deferrals are commonly thought of as "employee contributions" because an employee voluntarily elects to make them and forgo the receipt of cash compensation. However, the definitions for both elective contributions and elective deferrals refer to them as employer contributions.[46] In addition, elective contributions are treated as employer contributions regardless of whether they are made to a qualified or nonqualified CODA.[47] Whether or not such elective contributions are subject to current income tax to the employee, however, does depend on whether the CODA is a qualified or nonqualified CODA.[48]

Practice Insight: Elective contributions may also be referred to as "salary reduction contributions" because the employee elects to reduce his or her salary in order to make them.

Elective contributions also include catch-up contributions, discussed in VIII., below.

2. Matching Contributions

A "matching contribution" is an employer contribution made to a defined contribution plan, which can be based on an elective contribution, an employee after-tax contribution, or on account of a qualified student loan payment for contributions made for plan years beginning after December 31, 2023.[49] Regulations expand the definition to include any forfeiture allocated on the basis of after-tax, elective, or matching contributions, and clarify that matching contributions may be made at the discretion of the employer.[50] Contributions are included in the definition without regard to: (1) whether the contributions are forfeitable or nonforfeitable; (2) the conditions upon which the matching contributions may be distributed to the employees; or (3) the amount of the matching contributions (e.g., 50%, 100%, or 200% of the employee's elective contributions or after-tax contributions).[51] In addition, employer contributions under one qualified retirement plan will be treated as matching contributions even if they are made on account of elective contributions or after-tax contributions under a separate qualified plan (but not a nonqualified plan unless it is a SEP, SIMPLE IRA, §403(b) plan, or §501(c)(18) plan that is subject to §402(g)).[52]

> *Example:* An employer maintains a money purchase pension plan under which it makes an annual contribution for each plan year equal to 10% of each participant's compensation. To participate, an employee must elect to defer at least 3% of compensation under a qualified CODA maintained by the employer under a separate plan. The pension plan contribution for a given participant is made "on account of" the participant's elective contribution under the CODA, and is therefore a matching contribution under §401(m).

Practice Insight: Some contributions that are matching contributions in form may not be considered matching contributions within the definition of §401(m)(4)(A). For example, if a specified level of salary reduction contributions is required as a condition of employment or as a result of a one-time irrevocable election to participate in the plan, and this contribution is "matched" by the employer, the salary reduction contri-

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[41] Reg. §1.401(k)-1(a)(4)(ii), treating elective contributions made under a qualified CODA as employer contributions for purposes of §401(a), §401(k), §402, §404, §409, §411, §412, §415, §416, and §417.

[42] Reg. §1.401(k)-1(a)(5)(iii).

[43] Reg. §1.401(k)-1(5)(2)(ii), treating elective contributions made under a nonqualified CODA as nonelective contributions for purposes of §401(a) (including §401(a)(4)), §401(k), §404, §409, §411, §412, §415, §416, and §417 and excluding them from the requirements of §401(m) ACP testing.

[44] This is different from an "employee after-tax contribution," which is not deemed to be made under a CODA at all (regardless of whether it is a qualified or nonqualified CODA).

[45] §402(g)(3); Reg. §1.402(g)-1(b). See §6433(f)(2)(A)(i), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §103(a), effective for tax years beginning on or after January 1, 2027, which provides that the "Saver's Match" is to be treated as "an elective deferral made by the individual," even though it is referred to as a matching contribution in other parts of §6433. In general, the Saver's Match replaces the credit for qualified retirement savings contributions under §25B(b) and provides for a contribution of up to $2,000 for the tax year to be made by the Secretary to certain qualifying retirement plans, including a §401(k) plan.

[46] Reg. §1.401(k)-6; §402(g)(3); Reg. §1.402(g)-1(b).

[47] Reg. §1.401(k)-1(a)(4)(ii).

[48] §402(e)(3); Reg. §1.401(k)-1(a)(4)(ii), §1.401(k)-1(a)(5)(ii).

[49] *See* §401(m)(4)(A), as amended by Pub. L. No. 117-328, Div. T, §110(a). Section 401(m) contributions to a defined benefit plan were apparently intended to be considered matching contributions to the extent they are treated as contributions to a defined contribution plan under §414(k)(2), i.e., to the extent benefits are based on a separate account of a participant. *See* S. Rep. No. 445, 100th Cong., 2d Sess. at 169 (1988). For a discussion of contributions made on account of qualified student loan repayments, see II.F.1.c., below.

[50] Reg. §1.401(m)-1(a)(2)(i).

[51] *See* 1986 TRA Conf. Rep. II-392 and 394.

[52] Reg. §1.401(m)-1(a)(2)(ii); S. Rep. No. 445, 100th Cong., 2d Sess. at 169 (1988).

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bution may be a nonelective contribution,[53] in which case the match is not a matching contribution described in §401(m)(4)(A) or the regulations. In addition, contributions made on account of elective contributions but which are counted toward an employer's top-heavy plan minimum contribution requirement under §416(c) may not be considered as "matching contributions" under §401(m).[54] These contributions must therefore satisfy the general nondiscrimination rules of §401(a)(4).

For contributions made to a plan after December 29, 2022, a plan may allow a participant to designate matching contributions as Roth contributions.[55] Previously, employers were only permitted to make matching contributions as traditional, pretax contributions.

Employer contributions that are made before the deferral election is made, or before the services that relate to the elective contributions are performed (or if earlier, before the cash that subject to the deferral is available to the individual), are not considered matching contributions.[56] The IRS has relied on this rule to prohibit the use of surplus defined benefit plan assets that are transferred to a §401(k) plan under §4980(d) as matching contributions, reasoning that such amounts cannot be matching contributions because the contribution precedes the services with respect to which the elective contributions are made.[57] Similarly, an employer contribution is not a matching contribution if it is made on account of an employee after-tax contribution and contributed before that employee after-tax contribution.[58] Exceptions apply to forfeitures, allocation of shares from an ESOP loan suspense account (under certain conditions), or contributions occasionally made before employees' performance of services to accommodate bona fide administrative considerations and without any principal purpose of accelerating tax deductions.[59]

Matching contributions for self-employed individuals are treated the same as matching contributions for common-law employees, i.e., they are not treated as elective contributions and are not subject to the §402(g) limit or to the ADP test. This does not apply to qualified matching contributions that are treated as elective contributions for purposes of satisfying the ADP test.

3. *Profit-Sharing or Nonelective Employer Contributions*

The regulations define nonelective contributions in very general terms as "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."[60] Nonelective contributions are made to the individual accounts of employees based on a formula established in the plan and without regard to whether an employee elects to make any contributions to the plan.[61] In addition, nonelective contributions are not currently taxable to the employee at the time of contribution, accumulate earnings on a tax-free basis in the plan, and are taxed upon distribution to the participant or beneficiary.[62] The formula under the plan for allocating nonelective contributions is typically based on a percentage of compensation.

Nonelective contributions are commonly referred to as "profit-sharing contributions" or "discretionary profit-sharing contributions," neither of which is incorrect, but nonelective contribution is the operative term under the Code and regulations. The term profit-sharing contribution is not used in the Code and is used only colloquially in examples found in the regulations in the context of distinguishing contributions made pursuant to a cash or deferred election (i.e., elective deferrals) from all other types of plan contributions.[63] The use of nonelective contribution and profit-sharing contribution interchangeably is likely due to the fact that nonelective contributions are most commonly made pursuant to the terms of a profit-sharing plan.

A profit-sharing plan may be designed to provide for required or discretionary nonelective contributions, which allows employers to change the amount of the nonelective contributions from year to year or decide not to make a contribution for a particular year. However, if a 401(k) plan is designed to be "safe harbor plan" with respect to its elective deferrals, the employer must commit to making a certain level of nonelective contributions to the plan each year. Although the nonelective contributions are not subject to the ADP test, making nonelective contributions pursuant to a specific safe harbor formula is the means by which elective deferrals made under the CODA portion of the plan are deemed to satisfy the ADP test. Safe harbor plans are discussed in IV., below. In such a case, the nonelective contributions are also treated as "qualified nonelective employer contributions," as discussed below.

What distinguishes nonelective contributions from matching contributions is the fact that they are made without regard to whether or not the employee makes an election to defer any current compensation (unlike matching contributions) and the amounts contributed would not otherwise be payable to the employee as current compensation (unlike elective deferrals). In addition, the terms of the plan may impose a vesting schedule with respect to amounts attributable to nonelective contributions (unlike elective deferrals), but nonelective contributions must be fully vested at all times in order for them to be treated as qualifying nonelective employer contributions. Finally, nonelective contributions may be subject to less restrictive conditions for distributions than elective deferrals, as a plan may be designed to allow distributions after the amounts attributable to nonelective contributions after they have been held in the plan for at least two years[64] or upon the attainment of a stated age.[65]

Effective for contributions made after December 29, 2022, plans may provide participants the option to designate non-

[53] *See* II.B.1., below.
[54] Reg. §1.401(m)-1(c)(1).
[55] §402A(a)(2), added by Pub. L. No. 117-328, Div. T, §604(a).
[56] Reg. §1.401(m)-1(a)(2)(iii).
[57] PLR 200836035, PLR 200836034.
[58] Reg. §1.401(m)-1(a)(2)(iii).
[59] Reg. §1.401(m)-1(a)(2)(iii).
[60] Reg. §1.401(k)-6.
[61] Reg. §1.401-1(a)(2)(ii), §1.401-1(b)(1)(ii).
[62] §402(a).
[63] Reg. §1.401(k)-1(a)(3)(vii); *see also* Reg. §1.402(a)-1(e)(6).
[64] Rev. Rul. 71-295.
[65] Reg. §1.401-1(b)(1)(ii); however, a distribution on certain terms may still be subject to the 10% income tax if one of the events under §72(t) has not occurred.

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elective contributions as Roth contributions.[66] Previously, plans were only permitted to make nonelective contributions as traditional, pre-tax contributions.

4. Employee After-Tax Contributions

Employee after-tax contributions are contributions that employees elect to make to the plan on an after-tax basis. As opposed to elective contributions, after-tax employee contributions are treated as employee, as opposed to employer, contributions, and therefore are referred to simply as "employee contributions" in the regulations.[67] Although after-tax contributions are made pursuant to an election, they are not treated as part of a CODA.[68] To avoid any confusion, this Portfolio generally refers to these contributions as employee after-tax contributions.

Note: In practice, employee after-tax contributions are also referred to as "voluntary employee contributions," or thrift or savings contributions.

Employee after-tax contributions are defined to mean any contribution to a plan that is treated at the time of contribution as an after-tax employee contribution (e.g., by reporting the contribution as taxable income subject to applicable withholding requirements) and is allocated to a separate account to which attributable earnings and losses are allocated.[69] Such contributions also include amounts attributable to excess contributions under a CODA that are recharacterized as after-tax contributions, employee contributions to a defined contribution portion of a plan described in §414(k), employee contributions applied to a qualified cost-of-living arrangement described in §415(k)(2)(B), employee contributions applied to the purchase of whole life insurance protection or survivor benefit protection under a defined contribution plan, and employee contributions to an annuity contract described in §403(b).[70]

Employee after-tax contributions do not include Roth contributions, rollovers, repayments of loans, forfeiture "buy backs" under §411(a)(7)(C), or employee contributions that are transferred from another plan.[71]

Similar to employee after-tax contributions, Roth contributions are made on an after-tax basis; however, Roth contributions are subject to the limitations on elective deferrals (e.g., the annual limit under §402(g) and distribution limitations) and employee after-tax contributions are not. In addition, as elective deferrals, Roth contributions are subject to the ADP test, while employee after-tax contributions are subject to the ACP test. In addition, a qualified distribution of an amount attributable to a Roth account is entirely free from federal income tax. A distribution of an amount attributable to traditional after-tax employee contributions is generally taxable to the extent of any investment gain. The portion of each distribution that is allocable to investment gain is determined under rules specified in §72. These same rules generally apply to determine the tax treatment of a nonqualified distribution of an amount attributable to a Roth account.

Practice Insight: Employee after-tax contributions versus pre-tax elective deferrals are attractive for certain employers and employees. For example, pre-tax CODA contributions are generally only permitted to be withdrawn before age 59½ in the event of disability, hardship, or severance from employment. After-tax employee contributions may be withdrawn more freely. Because many employees are concerned about having their money tied up until age 59½, after-tax savings or thrift plans may attract greater numbers of participants. This, in turn, may make it easier for an after-tax plan than for a pre-tax plan to satisfy the applicable nondiscrimination tests.

5. Qualified Nonelective Employer Contributions (QNECs)

A qualified nonelective contribution (often called a QNEC) is defined as any employer contribution (other than a matching contribution) which is not subject to a cash or deferred election.[72] QNECs are a subsection of nonelective contributions discussed above.

QNECs must be nonforfeitable and subject to the elective deferral distribution restrictions under §401(k)(2)(B)(1) when allocated to participants' accounts.[73] QNECs are generally made to a plan to satisfy the safe harbor requirements (discussed in IV., below), correct an ADP or ACP test failure (discussed in III., below), or to correct another qualification issue.

[66] §402A(a)(3), added by Pub. L. No. 117-328, Div. T, §604(a).
[67] Reg. §1.401(m)-1.
[68] Reg. §1.401(k)-1(a)(2)(ii).
[69] Reg. §1.401(m)-1(a)(3).
[70] Reg. §1.401(m)-1(a)(3).
[71] Reg. §1.401(m)-1(a)(3)(ii).
[72] §401(m)(4)(C); Reg. §1.401(k)-6.
[73] Reg. §1.401(k)-6.

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II. Statutory Requirements for a Qualified CODA Under §401(k)

Section 401(k)(1) sets forth the general rule authorizing qualified CODA arrangements by providing that a profit-sharing or stock bonus plan (or a pre-ERISA money purchase pension plan or a rural cooperative plan) will not fail to satisfy the basic tax-qualification requirements of §401(a) merely because the plan includes a qualified CODA. In defining a qualified CODA, §401(k)(2) imposes various statutory requirements that it must satisfy, and §401(k)(4) contains additional statutory requirements, all of which are listed in I.C., above, and are discussed in detail in this section. However, the required ADP nondiscrimination test of §401(k)(3), and the related ACP test of §401(m) are discussed separately, in III., below.

As the goal of most qualified plans is to maintain a qualified CODA, this section focuses on the requirements for a qualified CODA and discusses nonqualified CODAs only to the extent necessary to highlight the more stringent rules that apply to qualified CODAs and the tax benefits associated with a qualified CODA.

A. CODA Must Be Part of a Tax-Qualified Profit-Sharing or Stock Bonus Plan: §401(k)(2)

The introductory language of §401(k)(2) generally provides that a qualified CODA is any arrangement which is part of a profit-sharing or stock bonus plan that meets the requirements of §401(a).[74] Section 401(k)(2) also provides limited exceptions that permit qualified CODAs to be maintained in connection with a pre-ERISA money purchase pension plan described in §401(k)(6) (a defined contribution plan that has been in existence since before June 28, 1974), or a rural cooperative plan described in §401(k)(7), if the plan meets the requirements of §401(a).[75] Thus, §401(k)(2) imposes two threshold requirements with regard to a qualified CODA: that it be included as part of a certain type of tax-qualified plan and that together, the tax-qualified plan and CODA satisfy all applicable provisions of §401(a).

1. Types of Tax-Qualified Plans That May Include a CODA

Most qualified CODAs are included as part of a profit-sharing or stock bonus plan. The regulations distinguish between profit-sharing and stock bonus plans, providing that a profit-sharing plan must "enable employees or their beneficiaries to participate in the profits of the employer's trade or business. . .pursuant to a definite formula for allocating the contributions and for distributing the funds,"[76] while a stock bonus plan must "provide employees or their beneficiaries benefits similar to those of profit-sharing plans, except that such benefits are distributable in stock of the employer, and that the contributions by the employer are not necessarily dependent upon profits."[77] The differences between a profit-sharing plan and stock bonus plan are discussed in greater detail in 354 T.M., *ESOPs.*

[74] §401(k)(2).

[75] §401(k)(1), §401(k)(6), §401(k)(7).

[76] Reg. §1.401-1(a)(2)(ii).

[77] Reg. §1.401-1(a)(2)(iii).

Money purchase pension plans cannot include a CODA unless the plan existed before June 28, 1974, which greatly limits the number of money purchase pension plans that can include a CODA today. Rural cooperative plans are much fewer in number compared to typical profit-sharing and stock bonus plans, as they are generally limited to the utility co-op industry, but they may include CODAs nonetheless. Defined benefit plans cannot include CODAs, with the exception of DB(k) plans,[78] which may only be sponsored by certain small employers. Employee stock ownership plans (ESOPs) may include CODAs by virtue of the fact that an ESOP is merely a feature, similar to a CODA, that must be included as part of a profit-sharing plan. In the case of ESOPs and DB(k) plans, however, the CODA is treated in large part as a separate plan. In the case of "starter 401(k) plans," which are available to employers for plan years beginning on or after January 1, 2024, the CODA is a separate plan and is the only feature of the plan, making it a unique type of qualified CODA.[79]

These various types of plans are discussed in more detail below as they relate their ability to include a §401(k) feature.

a. Profit-Sharing Plans

A profit-sharing plan is a type of defined contribution plan to which an employer makes discretionary contributions to participants' individual accounts that are not currently payable to the employees in cash. Contributions must be based on a formula established in the plan and are invested and accumulate earnings on a tax-free basis until distributed to the employee or his or her beneficiary. In order to distinguish profit-sharing plans from other types of tax-qualified plans, §401(a)(27) requires that a profit-sharing plan specifically designate that it is intended to be a profit-sharing plan.[80]

The regulations further define a profit-sharing plan as follows:

> A profit-sharing plan is a plan established and maintained by an employer to provide for the participation in his profits by his employees or their beneficiaries. The plan must provide a definite predetermined formula for allocating the contributions made to the plan among the participants and for distributing the funds accumulated under the plan after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment. A formula for allocating the contributions among the participants is definite if, for example, it provides for an allocation in proportion to the basic compensation of each participant.[81]

Despite the regulations' emphasis on profits in defining this type of plan, profits are not required for the employer to make contributions, and the amount of contributions is not lim-

[78] A DB(k) plan is a hybrid plan design, created as part of the Pension Protection Act of 2006 to help small employers minimize the cost of maintaining two qualified plans. A DB(k) plan combines the features of a §401(k) plan and a defined benefit pension plan. *See* §414(x).

[79] §401(k)(16), added by Pub. L. No. 117-328, Div. T, §121(a). For a discussion of starter §401(k) plans, see IV.F., below.

[80] §401(a)(27)(B).

[81] Reg. §1.401-1(b)(1)(ii).

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ited to the employer's current or accumulated profits.[82] A profit-sharing plan may provide for a discretionary contribution formula, which means that the amount of contributions can vary from year to year. In addition, it is within the discretion of the employer to determine, on an annual basis, whether to make any contributions for a particular year. Although an employer is not required to make contributions to the profit-sharing plan every year, or to contribute in the same amount or in accordance with the same ratio every year, the regulations require that contributions must be "recurring and substantial" in order for the plan to be considered ongoing.[83] Elective contributions made under a qualified CODA are treated as employer contributions for this purpose,[84] meaning that employees' elective deferrals can be used to satisfy the requirement that the employer make recurring and substantial profit-sharing contributions.

Practice Insight: Because elective deferrals under a qualified CODA are treated as employer contributions to the profit-sharing plan, there is essentially no requirement that an employer make any discretionary profit-sharing contributions or matching contributions in order to maintain a tax-qualified plan under §401(a) or to offer a qualified CODA under §401(k). As such, employers can use a 401(k) plan that is funded solely by elective deferral contributions from employee compensation to offer employees the opportunity to save for retirement, without incurring any liability for, or obligation to make, additional contributions. Thus, the decision to make discretionary profit-sharing contributions or matching contributions is typically driven by the desire to incentivize employees and remain competitive in the employment marketplace, rather than to satisfy any tax-qualification requirements.

However, the IRS's Employee Plans Guidelines state that if the employer has not made contributions in three of the past five consecutive years, the plan may have incurred a complete discontinuance of contributions, which requires the 100% vesting of all affected participants.[85] In light of this guidance, employers must monitor a 401(k) plan under which contributions are subject to a vesting schedule (i.e., the plan has contributions other than elective deferrals that are not 100% vested at all times) to make sure that there are no more than two plan years out the last five consecutive plan years for which no contributions are made, either in the form of discretionary profit-sharing contributions or employee elective deferral contributions.

The IRS appears to be enforcing the requirement that profit-sharing plans make contributions in three of the past five consecutive years. In 2016, it concluded the "Complete Discontinuance of Contributions Project" whereby it reviewed Forms 5500 and 5500-SF that reflected: (1) no contributions for the preceding five years (excluding 401(k) plans' employee deferral contributions); and (2) distributions. The goals of the project were to determine if a complete discontinuance of contributions occurred, and if so, to ensure participants were correctly 100% vested, and to determine if plan participants were incorrectly identified as partially vested terminated participants on incorrectly prepared Forms 5500/5500-SF. In the course of the project, the IRS found plans that had experienced a complete discontinuance of contributions and had incorrectly identified participants on the Form 5500 as terminated without 100% vesting. In these cases, the IRS required correction through EPCRS and the filling of an amended Form 5500. The IRS also found cases in which the facts and circumstances indicating the failure to make plan contributions did not rise to the level of a complete discontinuance and merely informed plan sponsors of the law on complete discontinuance of contributions for future reference. The IRS advised plan sponsors that had not made contributions to their profit-sharing plan for three of the past five years to consider the facts and circumstances to determine if a complete discontinuance of contributions had occurred, taking into account the history of profitability/ability to make contributions and whether they would be able to make contributions in the future.

b. Stock Bonus Plans

A stock bonus plan is another type of defined contribution plan to which an employer makes discretionary contributions to participants' individual accounts that are not currently payable to the employees in cash. As with a profit-sharing plan, contributions and distributions must be based on a formula established in the plan,[86] and contributions are invested and accumulate earnings on a tax-free basis until distributed to the employee or his or her beneficiary and are not limited by the amount of the employer's current or accumulated earnings and profits.[87]

Stock bonus plans provide benefits similar to those of profit-sharing plans, but benefits under a stock bonus plan must be distributed in employer stock, which is the primary difference between a stock bonus plan and a profit-sharing plan.[88] A stock bonus plan may also distribute benefits in cash but must allow the participant to demand that his or her benefits be distributed in employer stock.[89] If the employer securities are not readily tradable on an established market, the plan must provide a participant who is entitled to a distribution with the right to require that the employer repurchase the employer securities

[82] §401(a)(27)(A). Until 1986, the unique feature of qualified profit-sharing plans was that contributions thereto could be made only to the extent of the employer's current or accumulated earnings and profits. *See* Rev. Rul. 66-174, *obsoleted by* Rev. Rul. 91-8.

[83] Reg. §1.401-1(b)(1)(i).

[84] Reg. §1.401(k)-1(a)(4)(ii).

[85] IRM 7.12.1.4(6) (02-16-17). If a complete discontinuance of contributions is deemed to have occurred, all affected employees' rights to benefits accrued to the date of discontinuance, to the extent funded as of that date, or the amounts credited to the employees' accounts at that time, must be nonforfeitable (100% vested). IRM 7.12.1.4(8) (02-16-17). Whether a complete discontinuance of contributions has occurred is based on the facts and circumstances, including the employer's history of profitability and the probability of future contributions from the sponsor. If there has been a complete discontinuance of contributions and distributions from partially vested accounts have been made, the plan may become disqualified and must be corrected through EPCRS. Correction requires restoring previously forfeited accounts to affected participants, adjusted for lost earnings.

[86] Reg. §1.401-1(b)(1)(iii).

[87] Reg. §1.401-1(a)(2)(iii).

[88] Reg. §1.401-1(b)(1)(iii), §401(a)(23), §409(h), §409(o). If the employer stock is not readily tradable on an established market, the participant must have the right to require that the employer repurchase the employer stock under a fair valuation formula. For purposes of §409(h)(1)(B), a security is readily tradable on an established market if: (1) it is traded on a national securities exchange that is registered under §6 of the Securities Exchange Act of 1934, 15 U.S.C. §78f; or (2) it is traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and is deemed by the SEC to have a "ready market." Notice 2011-19; *see* Reg. §1.401(a)(35)-1(f)(5).

[89] §401(a)(23).

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under a fair valuation formula.[90] However, there is no requirement that the assets of a stock bonus plan be invested primarily in employer stock (unlike an employee stock ownership plan).[91]

An employer establishing a stock bonus plan, however, must be willing to allow its stock to remain in the hands of employees after their employment terminates.[92] Such a plan must provide that unless the participant elects otherwise, the distribution of the participant's account balance in the plan will: (1) commence not later than one year after the end of the plan year in which the participant separates from service due to attaining normal retirement age, disability or death or, in the case of separation from service for any other reason (without reemployment), the close of the plan year that is the fifth plan year following the plan year of the participant's separation from service, and (2) be paid in substantially equal periodic payments (at least annually) over a period no longer than five years or, if longer, five years plus an additional year for each of a specific increment by which the participant's account balance exceeds a certain amount, as each amount may be adjusted for inflation.[93]

c. *Money Purchase Pension Plans*

A money purchase pension plan is a type of defined contribution plan to which an employer agrees to make contributions to participants' individual accounts, without regard to the profits of the employer, and such contributions are typically based on a percentage of eligible participants' compensation. However, the minimum funding requirements of §412 and §430, which apply to defined benefit plans, also apply to money purchase pension plans, making employer contributions to money purchase pension plans mandatory rather than discretionary.

A qualified CODA can only be a part of a "pre-ERISA money purchase plan," but very few money purchase pension plans are able to satisfy the statutory requirements for a "pre-ERISA" plan.[94] As such, money purchase pension plans generally are not considered to be a type of plan that can include a qualified CODA.

Although the Treasury has previously supported the extension of §401(k) to all defined contribution pension plans,[95] no legislation that would accomplish this has ever been enacted. Further, there appears to be little pressure for legislation that would allow money purchase pension plans to include a qualified CODA given that money purchase pension plans have become much less common[96] and can be converted or merged into profit-sharing plans to allow for a CODA feature. The decline in the use of money purchase pension plans has been exacerbated by the fact that money purchase pension plans are, in some respects, subject to more onerous administrative requirements, particularly spousal consent and the minimum funding requirements.[97]

d. *Defined Benefit Plans*

A defined benefit plan is defined broadly to mean any type of plan that is not a defined contribution plan,[98] and it typically provides benefits based on a fixed formula that takes into account the participants' compensation and years of service. Annual employer contributions are mandatory and are based on actuarial estimates of the amounts needed to pay plan benefits. The minimum funding requirements of §412 and §430 apply to defined benefit plans. As §401(k)(2) only permits CODAs to be part of profit-sharing and stock purchase plans, a defined benefit pension plan may not include a qualified CODA.

However, §414(x) allows for certain small employers to maintain "eligible combined plans" consisting of both a defined benefit plan and a defined contribution plan with a qualified CODA, which are often referred to as "DB(k) arrangements."[99] Although a DB(k) arrangement is described as an eligible combined plan, the special rules of §414(x) require it to operate largely as two separate plans. DB(k) arrangements are discussed in more detail in IV.D., below, as they are also a type of design-based safe harbor plan that is deemed to satisfy the ADP and ACP nondiscrimination tests and is exempt from the top-heavy requirements of §416.[100]

e. *Employee Stock Ownership Plans (ESOPs)*

An ESOP is another type of defined contribution plan under which an employer makes contributions to participants' individual accounts that are invested and accumulate earnings on a tax-free basis until distributed to the employee or his beneficiary. An ESOP is defined in general terms by §4975(e)(7) as a stock bonus plan which is qualified under §401(a) and is designed to invest primarily in qualifying employer securities. Benefits under an ESOP, as a type of stock bonus plan, must be distributed in employer stock and are subject to the same rules under §409(o) and §409(h) as stock bonus plans regarding the right to require that the employer repurchase distributions made in employer stock under certain circumstances and the and timing of distributions. However, ESOPs are subject to a number of additional requirements under §409, including the requirement that an ESOP be invested primarily in employer stock, which is what distinguishes an ESOP from a stock bonus plan.

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[90] §401(a)(23), §409(h)(1).

[91] Reg. §1.401-1(b)(5)(i). This distinguishes a stock bonus plan from an employee stock ownership plan (ESOP), which must be designed to invest primarily in employer stock under §409(a)(2).

[92] §401(a)(23), §409(h), §409(o).

[93] §401(a)(23), §409(o)(1)(A).

[94] §401(k)(6) defines a pre-ERISA money purchase pension plan as a defined contribution plan that existed on June 27, 1974, included a salary reduction arrangement as of such date, and has neither employee nor employer contributions that exceed the levels provided for by the contributions formula in effect under the plan on such date.

[95] Statement of John E. Chapoton, Assistant Secretary of Treasury for Tax Policy, before the Select Revenue Subcommittee of the House Committee on Ways and Means, BNA Daily Tax Rpt. at J-26 (July 14, 1982).

[96] The historical advantages of maintaining a money purchase pension plan relative to a profit-sharing plan have largely evaporated. In this regard, contributions to a money purchase pension plan were previously subject to a more favorable deduction limit than contributions to a profit-sharing plan, which meant that employers with generous contribution formulas often maintained both a profit-sharing plan and a money purchase pension plan. §404(a)(3)(A)(i)(I), as in effect before the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16. However, legislation enacted in 2001 conformed the deduction limits between the two plan types. §404(a)(3)(A)(i)(I), as amended by EGTRRA, Pub. L. No. 107-16, §616(a)(1).

[97] Section 401(a)(11)(B), applying more rigorous spousal consent requirements to "any defined contribution plan which is subject to the funding standards," i.e., money purchase pension plans.

[98] §414(j).

[99] §414(x), added by 2006 PPA, Pub. L. No. 109-280, §903(a), and amended by Pub. L. No. 109-458, §109(c)(1), effective for plan years beginning after 2009.

[100] §414(x)(3), §414(x)(4).

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ESOPs are also subject to diversification requirements under §401(a)(28). The specific requirements of ESOPs are discussed in 354 T.M., *ESOPs.*

The regulations specifically provide that "[a]n ESOP may form a portion of a plan the balance of which includes a qualified pension, profit-sharing, or stock bonus plan which is not an ESOP".[101] Thus, both a qualified CODA and an ESOP may be part of the same tax-qualified plan, and such plans are often referred to as combined 401(k)/ESOPs or KSOPs. This type of arrangement allows for employees to make elective deferrals under the qualified CODA feature and for employers to make matching contributions in the form of employer stock, rather than cash. In addition, employees can elect to allocate their contributions to be invested in employer stock. However, the ESOP and 401(k) portions of the plan are treated as separate plans for purposes of satisfying the minimum coverage and nondiscrimination requirements of §410(b), which means that contributions to the ESOP are not taken into account in testing for the 401(k) portion of the plan, and vice versa.

2. *Tax-Qualified Plan With CODA Must Satisfy Applicable §401(a) Requirements*

A profit-sharing or stock bonus plan (or a pre-ERISA money purchase pension plan or rural cooperative plan) may include a qualified CODA only if the plan satisfies the other applicable requirements of §401(a), taking into account the CODA feature.[102] A discussion of all requirements under §401(a) is beyond the scope of this Portfolio, but the requirements of §401(a) that present unique issues as applied to tax-qualified plans including CODAs include the following:

- The overall plan contribution limits of §415(c) that are imposed under §401(a)(16);
- The compensation limits that are imposed under §401(a)(17);
- The top-heavy requirements of §416 that are imposed under §401(a)(10); and
- The diversification requirements that are imposed under §401(a)(35) on defined contribution plans that hold publicly traded employer securities and under §401(a)(28) on ESOPs.

The foregoing requirements of §401(a) are discussed in more detail below. There are additional tax-qualification requirements under §401(a) that are discussed elsewhere in this Portfolio as they as relate specifically to CODAs, which including the following:

- The §402(g) limitations on elective deferrals that are imposed under §401(a)(30) (discussed in VII., below);
- The §401(k)(3)(A)(ii) ADP nondiscrimination test, which is the only way that elective deferrals can satisfy the nondiscrimination requirement of §401(a)(4) (discussed in III., below); and
- The §401(m) ACP nondiscrimination test, which is the only way that employer matching contributions can satisfy the nondiscrimination requirement of §401(a)(4) (also discussed in III., below).

For a complete discussion of the general §401(a) requirements applicable to all profit-sharing and stock bonus plans, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*[103]

a. *Section 415 Limit on Contributions*

Under §401(a)(16), contributions to defined contribution plans ("annual additions") are subject to an overall annual limit under §415(c)(1) of 100% of the participant's "compensation" or $40,000 (as adjusted for inflation), whichever is less.[104] Annual additions for this purpose include elective deferrals, nonelective employer contributions, matching contributions, and after-tax employee contributions, as well as any forfeitures allocated to the employee's account.[105] However, §414(v) catch-up contributions, rollover contributions and certain restorative payments are not considered annual additions.[106]

Excess deferrals (i.e., elective deferrals that exceed the §402(g) limit) are not considered annual additions if they are distributed before April 15 of the year following the tax year in which the excess deferral was made.[107] Excess contributions (i.e., elective deferrals that would otherwise cause a plan to fail to satisfy the ADP test) are technically treated as annual additions even if the excess contributions are corrected through distribution.[108] However, as a practical matter, this is rarely an issue under §415 since a plan will ordinarily correct a §415 failure by first distributing elective deferrals and employee contributions. As discussed below, these amounts would not be taken into account in applying the ADP test so that it would be highly unusual, for example, for an elective deferral to constitute both an excess annual addition and an excess contribution.

For purposes of applying the §401(a)(16) limitations on contributions, "compensation" includes elective deferrals under a qualified CODA, a §403(b) arrangement, or a SIMPLE IRA, as well as amounts deferred at the employee's election under §457(b) and elective contributions that are excluded from gross

[101] Reg. §54.4975-11(a)(5).

[102] §401(k)(2); Reg. §1.401(k)-1(e)(1).

[103] *See also* 353 T.M., *Employee Benefit Plans and Issues for Small Employers*; 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*; 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.* Options available for correcting failures associated with these qualified plans through the Employee Plans Compliance Resolution Program System are discussed in 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[104] §415(c)(1)(A), §415(c)(1)(B). For years beginning before 2002, the limit was the lesser of 25% of the participant's compensation or $30,000 (as adjusted for inflation). For the current and previous dollar amounts, see the Worksheets.

[105] §415(c)(2). For purposes of this provision, employee contributions are determined without regard to rollover contributions and §414(v) catch-up contributions. Reg. §1.415(c)-1(b)(3)(i), §1.414(v)-1(d)(1).

Under §415(c)(1), benefits or employee contributions transferred from a qualified plan to a defined contribution plan are not annual additions. *See, e.g.*, PLR 201831006 (IRS approval of employer plan to allow eligible employees a one-time election to cease accruals under employer's DB plan and receive future accruals under employer's DC plan (a governmental §401(k) plan under §414(d), not subject to §411(d)(6)), with transferred amounts separately accounted for in DC plan; no requirement to report assets transferred in plan-to-plan transfer from the DB to DC plan as included in participants' gross income, and DC plan not required to treat transferred assets as annual additions under §415(c)).

[106] Reg. §1.415(c)-1(b)(2)(ii).

[107] Reg. §1.402(g)-1(e)(1)(ii), §1.415(c)-1(b)(2)(ii)(D).

[108] Reg. §1.415(c)-1(b)(1)(ii).

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income under §125, relating to cafeteria plans, and §132(f)(4), relating to salary reduction amounts used for qualified transportation benefits.[109] The term "compensation" does not include amounts paid after severance from employment unless such payments are made by the later of 2½ months after the severance from employment or the end of the limitation year that includes the date of severance and such amounts would have been paid to the employee while still employed or are payments for accrued bona fide sick, vacation or other leave.[110] As a result, severance is generally not considered "compensation" but ordinary payroll and leave cash-outs paid after severance from employment are included in "compensation."

The "annual addition" under a defined contribution plan is computed on the basis of a "limitation year." The limitation year is the calendar year, unless the employer elects to use some other consecutive 12-month period.[111]

Excess annual additions can be corrected under the Employee Plans Compliance Resolution System (EPCRS).[112] The correction method under EPCRS allows for the return of elective deferrals or employee contributions, and gains attributable to them, to reduce excess annual additions, subject to compliance with all other the terms and conditions of EPCRS. It also includes an explicit ordering rule providing for the distribution of different sources in a particular order, for example, first from any unmatched employee after-tax contributions and then unmatched elective deferrals. The returned amounts are disregarded for purposes of the §415 benefits and contributions limits, the §402(g) limits on elective deferrals, and the ADP and ACP nondiscrimination tests under §401(k)(3) and §401(m)(2), respectively.

b. Section 401(a)(17) Limit on Compensation

Section 401(a)(17) provides that a qualified plan may not take into account compensation in excess of a specified dollar amount. The statutory limit is $200,000, but it is adjusted for inflation in $5,000 increments.[113]

The §401(a)(17) limit applies for purposes of the nondiscrimination tests under §401(k)(3) and §401(m)(2).[114]

> *Example:* If an employee elects to defer $10,000 and has compensation of $400,000, the employee's actual deferral percentage for purposes of §401(k)(3) will be based on §401(a)(17) compensation, not the employee's true compensation of $400,000. In effect, §401(a)(17) acts as a part of the nondiscrimination testing regime.

Section 401(a)(17) is not relevant solely for nondiscrimination testing purposes. For example, if an employee elects to defer 5% of compensation, a plan would violate §401(a)(17) if elective contributions were based on $300,000 of compensation even if the resulting deferral of $15,000 were less than the §402(g) limit and the plan satisfied the nondiscrimination requirements taking into account only §401(a)(17) compensation. Instead, the plan must limit the employee's deferral to 5% of the §401(a)(17) compensation limit.

The prohibition on making contributions by reference to compensation in excess of the §401(a)(17) limit raises the question of whether elective deferrals may continue to be made once an employee has received compensation for the year in amount equal to the §401(a)(17) limit. On its face, this rule suggests that employees' elective deferrals must cease at this point, which could occur early in the plan year for very highly paid employees. Although the law is not entirely clear on this point, the IRS has indicated that §401(a)(17) compensation may be prorated over the year to allow highly paid employees to prorate their elective deferrals over the payroll periods in the plan year.[115] Thus, an employee should be able to defer the §402(g) limit over the entire year even though he or she earns an amount equal to the §401(a)(17) limit in less than the entire year. It is not clear, however, whether plans need specific language providing for proration of the §401(a)(17) limit and, if so, how such language should be drafted since an employee's plan year compensation may not be known at the time of each payroll.

> *Example:* Consider an employee who is paid $350,000 during the first half of 2025 when the annual §401(a)(17) limit is $350,000. Assume the employee elected to defer $1,000 per monthly payroll during the plan year, which is the calendar year. Section 401(a)(17) could be interpreted to prevent the employee from making elective deferrals during the second half of the year since all compensation paid in the second half of the year is in excess of the §401(a)(17) limit. However, assuming that the plan prorates §401(a)(17) compensation over the payroll periods in the plan year, the employee may make elective deferrals out of compensation paid during the second half of the year.

c. Section 416 Top-Heavy Rules

Section 401(a)(10)(B) requires that certain tax-qualified plans, including §401(k) plans, satisfy the top-heavy rules of §416. These rules compare the total account balances of key employees to the total balances of non-key employees. Generally, if more than 60% of the overall assets in the plan are attributable to key employees, the plan is deemed to be top-heavy and certain minimum contributions may need to be provided to the non-key employees and certain vesting requirements must be satisfied. Thus, the top-heavy rules provide an additional layer of nondiscrimination testing to ensure that a plan does not disproportionately benefit "key employees."

Section 416(g)(4)(H) provides that a "top-heavy" plan does not include a plan consisting solely of: (1) a CODA that meets the ADP safe harbor requirements of either §401(k)(12) or §401(k)(13); and (2) matching contributions that meet the requirements of §401(m)(11) or §401(m)(12). If, but for this

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[109] §415(c)(3)(D).

[110] Reg. §1.415(c)-2(e)(3).

[111] Reg. §1.415(j)-1(a).

[112] T.D. 9319, 72 Fed. Reg. 16,878, 16,888 (Apr. 5, 2007) (preamble to final §415 regulations). Rev. Proc. 2021-30, §6.06(2) (effective July 16, 2021), *superseding* Rev. Proc. 2019-19, §6.06(2). For discussion of EPCRS, see 375 T.M., *EPCRS — Plan Correction and Disqualification*.

[113] §401(a)(17). The limit is $350,000 for 2025 and was $345,000 for 2024 and $330,000 for 2023. Notice 2024-80 (2025 limit), Notice 2023-75 (2024 limit), Notice 2022-55 (2023 limit). For previous dollar amounts, see the table in the Worksheets.

[114] Reg. §1.401(a)(17)-1(c)(1).

[115] Reg. §1.401(a)(17)-1(b)(3)(ii).

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provision, a plan would be treated as top-heavy because it is a member of an aggregation group that is a top-heavy group, contributions under the plan may be taken into account in determining whether any other plan in the group meets the top-heavy defined contribution plan requirements of §416(c)(2).[116] In addition, §414(x)(4) provides that a §401(k) plan forming part of a DB(k) plan, discussed in IV.D., below, is treated as meeting the top-heavy requirements.

A plan will not be treated as top-heavy solely because it does not provide for nonelective or matching contributions to employees who are eligible to participate on the basis of being long-term, part-time employees under §401(k)(2)(D)(ii),[117] which means that the plan can be tested without such participants.[118] Effective for plan years beginning on or after January 1, 2024, employees not meeting the age or service requirements of §410(a)(1), without regard to §410(a)(1)(B), may be excluded in determining a plan's top-heavy status.[119]

Also, employer matching contributions (as defined in §401(m)(4)(A)) are taken into account in determining whether the plan provides the required minimum benefits under §416(c).[120] However, any reduction in the minimum contribution under this provision is not taken into account in determining whether the contingent benefit rule of §401(k)(4)(A) applies.[121] Under the regulations, elective contributions pursuant to a CODA on behalf of key employees are taken into account in determining any minimum required contribution for non-key employees under §416(c)(2),[122] but elective contributions may not be treated as employer contributions for non-key employees in determining whether the minimum contribution rule has been satisfied.[123]

Practice Insight: To the extent that the §416 requirements for a top-heavy plan are not already satisfied by a top-heavy plan that contains a CODA, or by another plan of the employer, the employer may wish to impose back-up limits on the elective contributions by key employees under the CODA, to prevent that plan (or an "aggregation group" of plans, as defined in §416(g)(1)(B)) from becoming top-heavy, or to limit the minimum employer contribution that will need to be made.

d. Section 401(a)(35) and §401(a)(28) Diversification Requirements

Section 401(a)(35) requires certain defined contribution plans that hold employer stock, including 401(k) plans, to allow participants and beneficiaries to reinvest any amounts contributed as elective deferrals (and after-tax employee contributions) in an investment option other than employer stock. These "diversification rights" afforded by §401(a)(35) only apply to plans that hold publicly traded employer securities, but a similar rule under ERISA §204(j) applies to plans that hold non-publicly traded or privately held employer securities. In addition, §401(a)(28) affords diversification rights to ESOPs, including a KSOP. Each of these provisions is discussed below.

(1) Publicly Traded Employer Securities

(a) General Rule

Section 401(a)(35), as applied to 401(k) plans, generally provides that a §401(k) plan may not require an individual to invest in publicly traded employer securities.[124] Specifically, §401(a)(35) requires that a §401(k) plan provide individuals with an immediate opportunity to elect to direct the investment of the portion of the participant's account that is attributable to elective deferrals, employee contributions, and rollover contributions among a menu of diversified investment options other than employer stock.[125] Thus, in principle, an employer could make contributions attributable to elective deferrals in the form of publicly traded employer securities and then require that participants affirmatively elect to diversify their accounts. However, the practical effects of this rule are to require the terms of a 401(k) plan to provide for diversification rights, and for the plan to include sufficient investment options.

It is more common for employers to make matching contributions in the form of employer securities. For the portion of a participant's account balance that is invested in employer

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[116] §416(g)(4)(H).

[117] *See* Prop. Reg. §1.401(k)-5(b)(1), REG-104194-23, 88 Fed. Reg. 82,796 (Nov. 27, 2023). For this purpose, long-term, part-time employees are part-time employees who work at least 500 hours for three consecutive years (two for plan years beginning in or after 2025) and satisfy minimum age requirements. See II.E., below.

[118] *See* §401(k)(15)(B)(ii); Prop. Reg. §1.401(k)-5(d)(2)(ii), §1.401(k)-5(f)(2), REG-104194-23, 88 Fed. Reg. 82,796, 82,814 (Nov. 27, 2023). Although §401(k)(2)(D)(ii) is effective for plan years beginning on or after January 1, 2021, the statute requires that an employee complete at least 500 hours of service for three consecutive 12-month periods, which means that January 1, 2024, is the earliest date that this provision could apply to a part-time employee. For plan years beginning after 2024, the service requirement must be satisfied for two consecutive 12-month periods, instead of three.

[119] §416(c)(2)(C), added by Pub. L. No. 117-328, Div. T, §310(a). *See also* Prop. Reg. §1.401(k)-5(f)(2), REG-104194-23, 88 Fed. Reg. at 82,816.

[120] §416(c)(2)(A), as amended by EGTRRA, Pub. L. No. 107-16, §613(b), effective for years beginning after December 31, 2001. This provision overrides Reg. §1.416-1, Q&A M-19, which provides that, if matching contributions are used to satisfy the minimum benefit requirement, they are not treated as matching contributions for purposes of the §401(m) nondiscrimination rules. H.R. Conf. Rep. No. 84, 107th Cong, 1st Sess. 121, n. 69 (2001).

[121] §416(c)(2)(A). The contingent benefit rule is discussed in II.F.1., below.

[122] Reg. §1.416-1, Q&A M-20.

[123] Reg. §1.416-1, Q&A M-20. Apparently, the Treasury Department concluded that this rule was necessary in light of the addition of §401(k)(4)(A) and §401(k)(4)(C) by the 1986 TRA, which generally prohibits the conditioning of any other benefit (e.g., the top-heavy minimum) on an employee's making, or failing to make, elective contributions under a CODA, and also prohibit elective contributions under a CODA from being taken into account for purposes of determining whether any other plan meets the requirements of §401(a).

[124] §401(a)(35), added by Pub. L. No. 109-280, §901(a)(1), generally effective for plan years beginning after December 31, 2006. *See* Reg. §1.401(a)(35)-1, T.D. 9484, 75 Fed. Reg. 27,927 (May 19, 2010), generally effective for plan years beginning on or after January 1, 2011. For plan years beginning in 2007 through 2010, a plan could rely on Notice 2006-107 (as modified by Notice 2008-7), proposed regulations contained in REG-136701-07, 73 Fed. Reg. 421 (Jan. 3, 2008), or the final regulations to satisfy the requirements of §401(a)(35). 75 Fed. Reg. at 27,930 (preamble). A special effective date applied for a plan maintained pursuant to one or more collective bargaining agreements ratified on or before August 17, 2006. Pub. L. No. 109-280, §901(c)(2); Reg. §1.401(a)(35)-1(g)(1)(ii). Also, for employer matching and nonelective contributions (and earnings thereon) that are invested in employer securities that as of September 17, 2003, (1) consisted of preferred stock and (2) were held within an ESOP under the terms of which the value of the preferred stock is subject to a guaranteed minimum, §401(a)(35) applied to the preferred stock for plan years beginning after the earlier of: (a) December 31, 2007; or (b) the first date as of which the actual value of the preferred stock equaled or exceeded the guaranteed minimum. Pub. L. No. 109-280, §901(c)(3).

[125] §401(a)(35)(B); Reg. §1.401(a)(35)-1(b)(1). *See* §401(a)(35)(G)(ii) (defining elective deferrals as employer contributions described in §402(g)(3)(A)).

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stock and is attributable to employer contributions other than elective deferrals, such as matching contributions, §401(a)(35) requires that a participant who has completed at least three years of service have the right to diversify such portion of their account balance.[126] The date of completion of three years of service occurs immediately after the end of the third vesting computation period provided for under the plan that constitutes the completion of a third year of service under §411(a)(5). However, if the plan uses the elapsed time method of crediting service for vesting purposes (or provides for immediate vesting), the date of completion is the third anniversary of the participant's date of hire.[127]

Affected individuals must have the right to reinvest in an investment menu that includes no fewer than three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics.[128] Investment options are treated as being diversified and having materially different risk and return characteristics if they satisfy the requirements of 29 C.F.R. §2550.404c-1(b)(3).[129] This requirement is ordinarily not an issue for plans that permit participants to direct the investment of their account balances. In addition, a plan may limit the time for divestment and reinvestment to periodic, reasonable opportunities but must permit diversification at least as frequently as on a quarterly basis.[130]

(b) Definition of Publicly Traded Employer Security

A publicly traded employer security is any security issued by an employer of employees covered by the plan, or by an affiliate of such employer, which is readily tradable on an established securities market.[131] A security is readily tradable on an established securities market only if it is traded on a national securities exchange that is registered under §6 of the Securities Exchange Act of 1934.[132] Thus, securities that are only traded on the "Over-The-Counter Bulletin Board" and the "pink sheets" are not considered publicly traded only on securities.[133] Similar rules apply to securities that are traded on a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority and the security is deemed by the SEC as having a "ready market" under SEC Rule 15c3-1.[134] Effective for plan years beginning on or after January 1, 2028, §401(a)(35)(I) provides several additional means by which an employer security will be treated as publicly traded for this purpose.[135]

An employer cannot simply bypass the diversification requirements of §401(a)(35) by issuing a special class of non-publicly traded securities to a §401(k) plan. The statute provides that a plan holding non-publicly traded securities will be treated as holding publicly traded securities if the employer, or any member of controlled group of corporations[136] which includes the employer, has issued as a class of stock which is publicly traded.[137] For this purpose, the controlled group rules are applied using a 50% threshold rather than an 80% threshold.[138] There is a limited exception that is intended to cover situations where a brother-sister corporation that does not include its employees in the plan has a publicly traded security.[139]

A plan (including an investment option under the plan) is not treated as holding employer securities to the extent the employer securities are held indirectly as part of a broader fund that is:

(1) a regulated investment company in §851(a);

(2) a common or collective trust fund or pooled investment fund maintained by a bank or trust company supervised by a state or a federal agency;

(3) a pooled investment fund of an insurance company that is qualified to do business in a state;

(4) an investment fund managed by an investment manager as defined under ERISA §3(38) for a multiemployer plan; or

(5) any other investment fund designated by the IRS in published guidance.[140]

This exception applies only if the investment in the employer securities is held in a fund under which there are stated investment objectives of the fund and the investment is independent of the employer and any affiliate.[141] Under the percentage limitation rule, an investment is not considered to be independent if the aggregate value of the employer securities held in the fund exceeds 10% of the total value of all of the fund's investments for the plan year, determined as of the end of the preceding plan year.[142] If an investment fund no longer meets the independent investment requirement (or the percentage limitation rule), the plan does not fail the diversification requirements merely because it does not offer those rights with respect to that investment fund for up to 90 days after the investment fund ceases to meet those requirements.[143]

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[126] §401(a)(35)(C); Reg. §1.401(a)(35)-1(c). *See* §401(a)(35)(G)(vi) (defining year of service).

[127] Reg. §1.401(a)(35)-1(c)(3). *See* Notice 2006-107, §III.B.

[128] §401(a)(35)(D).

[129] Reg. §1.401(a)(35)-1(d). *See* Notice 2006-107, §III.C.

[130] §401(a)(35)(D)(ii)(I); Reg. §1.401(a)(35)-1(b)(1), §1.401(a)(35)-1(c)(1).

[131] §401(a)(35)(G)(iii) (citing to ERISA §407(d) for definition of employer security).

[132] Reg. §1.401(a)(35)-1(f)(5).

[133] REG-136701-07, 73 Fed. Reg. 423–24 (preamble to §401(a)(35) proposed regulations).

[134] Reg. §1.401(a)(35)-1(f)(5).

[135] *See* §401(a)(35)(I), added by Pub. L. No. 117-328, Div. T, §123(a), effective for plan years beginning after December 31, 2027.

[136] §414(b) (which references §1563(a) without regard to §1563(a)(4) and §1563(e)(3)(C)).

[137] §401(a)(35)(F). A transition rule applied to the portion of an account that consists of employer securities acquired in a plan year before January 1, 2007. Under the transition rule, for the first three years for which the diversification rules apply, the applicable percentage of such amounts subject to diversification is 33% in the first year, 66% in the second year and 100% in the third and following years. The applicable percentage separately applies to each class of employer security in an applicable individual's account. The transition rule did not apply to plan participants who had three years of service and who had not reached age 55 by the beginning of the first plan year beginning after December 31, 2005. §401(a)(35)(H); Reg. §1.401(a)(35)-1(g)(3); Notice 2006-107, §III.E.

[138] §401(a)(35)(F)(iii); Reg. §1.401(a)(35)-1(f)(2)(iv)(A).

[139] §401(a)(35)(F)(ii); Reg. §1.401(a)(35)-1(f)(2)(iv)(B).

[140] Reg. §1.401(a)(35)-1(f)(3)(ii)(A).

[141] Reg. §1.401(a)(35)-1(f)(3)(ii)(B).

[142] Reg. §1.401(a)(35)-1(f)(3)(ii)(C). The determination can be based on the information in the latest disclosure of the fund's portfolio holdings that was filed with the SEC in that preceding plan year.

[143] Reg. §1.401(a)(35)-1(e)(2)(iii)(B). *See* Notice 2006-107, §III.A.

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(c) *Investment Restrictions and Conditions*

A plan generally is not permitted to impose restrictions or conditions with respect to the investment of publicly traded employer securities that are not imposed on the investment of other assets of the plan and may not condition other benefits on investments in employer securities.[144]

Prohibited restrictions and conditions, whether imposed directly or indirectly, typically include:

(1) a restriction on an applicable individual's rights to divest an investment in employer securities that is not imposed on an investment that is not in employer securities; thus, for example, a plan may not provide that investment control is offered less frequently for an employer stock fund than other investment funds; and

(2) a benefit that is conditioned on investment in employer securities.[145]

A prohibited indirect restriction on an individual's right to divest an investment in employer securities would be, for example, one that prohibits a participant who divests his or her account balance with respect to the investment in employer securities from reinvesting in employer securities for a period of time thereafter.[146] The notion is that an individual may be unwilling to diversify if diversification means that the individual will be limited in his or her ability to invest in employer securities. However, an indirect restriction would not exist merely because there are tax consequences that result from an individual's divestment of an investment in employer securities, such as, for example, the loss of the special treatment for net unrealized appreciation provided under §402(e)(4).[147]

There are carve-outs from this rule, provided the limitation applies without regard to a prior exercise of rights to divest employer securities. For example, the plan may prohibit a participant from investing additional amounts in employer securities if more than 10% of that participant's account balance is invested in employer securities.[148] A plan also may impose reasonable restrictions on the timing and number of investment elections an individual can make to invest in employer securities, provided the restrictions are designed to limit short-term trading in the employer securities. For example, under a so-called round trip restriction, a plan could provide that a participant may not elect to invest in employer securities if the employee has elected to divest employer securities within a short period of time, such as seven days, before the election to invest in employer securities.[149] The seven-day rule is an example; other short-term trading restrictions (such as a restriction based on multiple trades within a specified period) are allowable if they meet the "reasonably designed" standard. A restriction or condition on the divestiture of employer securities that either is required or is reasonably designed to ensure compliance with applicable securities laws is permitted.[150] Also, an applicable defined contribution plan may restrict the application of the diversification requirements for up to 90 days after the plan becomes an applicable defined contribution plan (for example, because the employer securities held under the plan first become publicly traded).[151]

A plan may impose fees on other investment options that are not imposed on the investment in employer securities, or may impose a reasonable fee for the divestment of employer securities.[152] A plan may allow transfers to be made into or out of a stable value or similar fund more frequently than a fund invested in employer securities. A stable value fund or similar fund is an investment product or fund designed to preserve or guarantee principal and provide a reasonable rate of return, while providing liquidity for benefit distributions or transfers to other investment alternatives.[153] A plan may provide for transfers out of a qualified default investment alternative (QDIA)[154] more frequently than a fund invested in employer securities.[155] Finally, a plan may prohibit any further investment in employer securities only if the plan does not permit additional contributions or other investments to be invested in employer securities.[156] A plan is not considered to provide for further investment in employer securities merely because dividends paid on employer securities under the plan are reinvested in employer securities.[157]

(d) *Exception to Diversification for ESOPs and One-Participant Plans*

The diversification requirements of §401(a)(35) apply very broadly. Any defined contribution plan that holds publicly traded employer securities must provide the diversification rights. The only exceptions are for a one-participant plan or an ESOP that does not hold any amounts attributable to elective deferrals under §401(k) or matching contributions under §401(m), and that is structured as a separate plan within the meaning of §414(l).[158] A one-participant retirement plan is defined for this purpose as a retirement plan that on the first day of the plan year: (1) covered only one individual (or the individual and the individual's spouse) who (or with his or her spouse) owned 100% of the plan sponsor (whether or not incorporated); or (2) covered only one or more partners (or partners and their spouses) in the plan sponsor.[159] An ESOP is an applicable defined contribution plan if it is a portion of a larger plan (whether or not that larger plan includes contributions that are subject to

[144] §401(a)(35)(D)(ii)(II); Reg. §1.401(a)(35)-1(e).

[145] Reg. §1.401(a)(35)-1(e)(1)(i).

[146] Reg. §1.401(a)(35)-1(e)(1)(ii)(B).

[147] Reg. §1.401(a)(35)-1(e)(1)(ii)(C).

[148] Reg. §1.401(a)(35)-1(e)(3)(ii).

[149] Reg. §1.401(a)(35)-1(e)(3)(iii).

[150] Reg. §1.401(a)(35)-1(e)(2)(ii). *See* T.D. 9484, 75 Fed. Reg. at 27,930 (preamble).

[151] Reg. §1.401(a)(35)-1(e)(2)(iii)(A).

[152] Reg. §1.401(a)(35)-1(e)(3)(iv).

[153] Reg. §1.401(a)(35)-1(e)(3)(v).

[154] Defined in 29 C.F.R. §2550.404c-5(e). See discussion of QDIAs in 365 T.M., *ERISA — Fiduciary Responsibility and Prohibited Transactions.*

[155] Reg. §1.401(a)(35)-1(e)(3)(vi).

[156] Reg. §1.401(a)(35)-1(e)(3)(vii).

[157] Also, an ESOP does not fail to be a frozen fund merely because of the allocation of employer securities that are released as matching contributions from the plan's suspense account that holds employer securities acquired with an exempt loan under §4975(d)(3), but only as to employer securities that were acquired in a plan year beginning before 2007, with the proceeds of an exempt loan which is not refinanced after the end of the last plan year beginning before 2007.

[158] §401(a)(35)(E). *See* Notice 2006-107, §III.A.

[159] §401(a)(35)(E)(iii) and §401(a)(35)(E)(iv), as amended by Pub. L. No. 110-458, §109(a), effective as if included in the 2006 PPA; Reg. §1.401(a)(35)-1(f)(2)(iii).

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§401(k) or §401(m)). A plan is not considered to hold amounts ever subject to §401(k) or §401(m) merely because the plan holds amounts attributable to rollover amounts in a separate account that were previously subject to §401(k) or §401(m).[160]

Practice Insight: The separate plan requirement means that an employer cannot make nonelective employer contributions to an ESOP component of a §401(k) plan. Instead, the employer must establish a stand-alone ESOP to receive such contributions. It appears that this may be accomplished through a spin-off of any assets attributable to §401(k) or §401(m) contributions, including amounts previously attributable to such contributions where the plan no longer permits such contributions.

(e) ERISA Notice Requirement

ERISA §204(j) imposes diversification requirements that mirror the requirements of §401(a)(35). ERISA §101(m) imposes a notice requirement in addition to the substantive requirements discussed above. The notice must inform individuals of their right to diversify under ERISA §204(j) and must describe the importance of diversifying the investment of retirement account assets. The notice is due no later than 30 days before the first date on which an individual has the right to diversify.[161]

The IRS has issued a model notice for use under ERISA §101(m).[162]

The penalty for failure to provide the notice may be as high as $100 (as adjusted for inflation) per participant per day.[163]

(2) ERISA Limitation on Privately Held Employer Securities

As discussed above, §401(a)(35) does not apply if the employer and its affiliates do not have publicly traded securities. In circumstances where the diversification requirements of §401(a)(35) and ERISA §204(j) do not apply to a §401(k) plan, certain ERISA rules may limit the extent to which participants may be required to invest elective deferrals in employer securities. Specifically, ERISA §407(a) imposes a 10% limit on investments by employee pension benefit plans in qualifying employer securities and qualifying employer real property. This limitation extends to elective deferrals under a §401(k) plan requiring any portion of elective deferrals or earnings on elective deferrals to be so invested.[164] Thus, §401(k) plans cannot require employees to invest more than 10% of their §401(k) plan contributions in qualifying employer securities, including privately held employer securities, or qualifying employer real property.

There are several exceptions to this rule. First, the rule does not apply to an individual account plan if, pursuant to the terms of the plan, the portion of any employee's applicable elective deferrals which is required to be invested in qualifying employer securities and qualifying employer real property for any year may not exceed 1% of the employee's compensation which is taken into account under the plan in determining the maximum amount of the employee's applicable elective deferrals for such year.[165] Second, the 10% limit does not apply to an individual account plan if the fair market value of the assets of all individual account plans maintained by the employer does not exceed 10% of the fair market value of the assets of all retirement plans (other than multiemployer plans) maintained by the employer.[166] Third, the change does not apply to an ESOP, as defined in §4975(e)(7).[167]

Practice Insight: The last exception for ESOPs is significant. A qualified CODA may be a component of a stock bonus plan, including an ESOP. The requirements for ESOPs are not particularly onerous and, for this reason, it is possible to design a so-called KSOP that requires the investment of elective deferrals in privately held employer securities.

(3) Section 401(a)(28) Diversification Rights for ESOPs

Section 401(a)(28) creates diversification rights in an ESOP, including a KSOP. Pursuant to §401(a)(28), an employee who has completed at least 10 years of participation under the plan and has attained age 55 (a "qualified participant") must be provided an opportunity to either receive a distribution of a portion of his or her account or, more commonly, invest among a diversified menu of investment options.[168] The election must be available for the six-plan-year period beginning when the employee first became a qualified participant, and must apply to 25% of the participant's account in the plan.[169] However, in the last year of the election period, 50% of the participant's account must be eligible for diversification.[170]

ERISA §407 and I.R.C. §401(a)(28) do not limit voluntary investments in employer securities. Thus, employees may elect to invest more than 10% of their elective deferrals in employer securities and real property. Further, employers still can invest their matching contributions in non-publicly traded employer stock or real property, as long as employees are not required to

[160] §401(a)(35)(E)(ii); Reg. §1.401(a)(35)-1(f)(2)(ii).

[161] ERISA §101(m). The DOL issued transition guidance that effectively waived the diversification notice for individuals that became eligible to diversify prior to January 1, 2007, when the notice requirement was first effective. Because the information regarding the importance of diversification is required under both the stock diversification notice under ERISA §101(m) and the quarterly benefit statements under ERISA §105, the DOL treated a plan administrator's compliance with the benefit statement requirement as satisfying the diversification notice requirement for plans that were providing employer stock diversification rights at least equal to those required by the 2006 PPA. DOL Field Assistance Bulletin 2006-03.

[162] Notice 2006-107, §III.G. The model may have to be adapted to reflect particular plan provisions. For example, changes would generally be necessary if the plan has more than one class of employer securities, the plan provides the same diversification rights for participants without regard to whether they have three years of service, some of the plan's investment options are closed, the plan receives participant elections electronically, or the transition rule of §401(a)(35)(H) is being applied. Notice 2006-107, §III.G.

[163] ERISA §502(c)(7); 29 C.F.R. §2575.3. For a table of the current and prior DOL penalties imposed on an ERISA plan, see the Worksheets of 361 T.M., *Reporting and Disclosure Under ERISA*. The penalty accrues from 30 days before the first date on which rights are exercisable under ERISA §204(j) up to the date the notice is furnished. 29 C.F.R. §2560.502c-7.

[164] ERISA §407(b), as amended by Pub. L. No. 105-34, §1524. *See also* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 750–51 (1997). The 10% limit applies to elective deferrals for plan years beginning after December 31, 1998.

[165] ERISA §407(b)(2)(B)(iv).

[166] ERISA §407(b)(2)(B)(ii).

[167] ERISA §407(b)(2)(B)(iii).

[168] §401(a)(28)(B); *see also* Notice 88-56.

[169] §401(a)(28)(B).

[170] §401(a)(28)(B)(i).

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invest more than 1% of their elective deferrals in such investments. Therefore, participants may assume the risk of investing more than 10% of their assets in the stock of their employer. In addition, the assets invested in qualifying employer securities and qualifying employer real property above the 10% limitation pursuant to employee direction can qualify for ERISA §404(c) protection (relating to participant-directed accounts).

B. CODA Must Offer Election by Employee to Contribute to a Trust: §401(k)(2)(A)

Section 401(k)(2)(A) provides that a qualified CODA is an arrangement under which a covered employee may elect to have the employer make payments as contributions to a trust under the plan on behalf of the employee, or to the employee directly in cash.

Whether or not a contribution is made pursuant to an election by the employee is critical not only in determining whether a qualified versus a nonqualified CODA arrangement exists under §401(k) but in distinguishing between elective and nonelective employer contributions for purposes of applying the general tax-qualification rules of §401(a). In this regard, for example, a contribution that is made as a result of a cash or deferred election under a qualified CODA is subject to the §402(g) limit while a nonelective contribution is subject only to the broader §415 limit. Similarly, a contribution made pursuant to a qualified cash or deferred election is subject to the ADP test while a nonelective employer contribution is subject to an entirely different set of nondiscrimination testing rules under §401(a)(4). In other words, identifying whether a plan contribution is made pursuant to a cash or deferred election is also necessary to determine the type of contribution being made to the plan, which affects when such contribution will be taxable to the employee, and any limitations on the amount or distribution of the contribution under the general tax-qualification rules of §401(a).

The concept of an election can also be significant to employers and plans that are ineligible to maintain a qualified CODA, such as governmental plans and defined benefit plans, as the inadvertent creation of a CODA by offering an employee a choice between benefits can disqualify the entire plan. For example, if an employer offered an employee a choice between participation in a defined benefit plan or a higher salary, this choice would create a cash or deferred arrangement, unless, as discussed below, such choice was offered as part of a one-time irrevocable election prior to the date the employee became eligible under any tax-preferred plan maintained by the employer. If the employee elected participation in the defined benefit plan, the employee might be subject to current income tax on the value associated with such participation, and the tax-qualified status of the defined benefit plan could be adversely affected.

1. Meaning of "Election"

A cash or deferred election is defined broadly by the regulations as any "direct or indirect election (or modification of an earlier election) by an employee" between having the employer "provide cash (or some other taxable benefit) that is not currently available" and "contribute an amount to a trust, or provide an accrual or other benefit, under a plan deferring the receipt of compensation."[171] This general definition applies both to qualified and nonqualified CODA arrangements. For a CODA to be a *qualified* CODA, the regulations impose the additional requirement that the amount that may be deferred under the election must be available in cash, which effectively negates the application of the "some other taxable benefit" parenthetical of the general CODA definition of the regulations to qualified CODAs.[172]

It is important to recognize that not all contributions made under a salary reduction agreement will constitute elections to make pre-tax deferrals under a qualified CODA. For example, contributions made under a mandatory salary reduction agreement entered into as a condition of employment are not contributions made pursuant to cash or deferred elections because there is no "election" by the employee to receive contributions in lieu of cash.[173] Contributions made under these circumstances are subject to the general coverage and nondiscrimination requirements applicable to nonelective employer contributions, which demonstrates how the election concept is important in determining whether a contribution is made under a qualified CODA.

Implicit in the definition of a cash or deferred arrangement is that a choice to receive a distribution from the plan is not considered a choice between cash or deferred election. For example, if a nonelective contribution is made on behalf of a participant and is immediately eligible for distribution because the participant has attained a stated age, such as age 55, it could be argued that a cash or deferred election exists because the participant can request an immediate distribution and receive cash, or choose not to receive a distribution and, therefore, receive the contribution. In such a case, however, the cash distribution would be made pursuant to the terms of the plan and would not be made by the employer. In the absence of a choice to receive a payment from the employer, no election exists within the meaning of a CODA under the regulations.

The following discussion explains in more detail the specific requirements for an election to be treated as having been made pursuant to a *qualified* CODA.

a. Amount Deferred Under Election Must Be Available in Cash

As discussed above, the amount deferred under the employee's election must be available to the employee in cash in order for the arrangement to be a qualified CODA, notwithstanding the parenthetical reference to "some other taxable benefit" in the general definition of a cash or deferred election.[174] Thus, if an employee's election involves a choice between a non-cash taxable benefit and a contribution of equal value, the arrangement may be a CODA, but it will not be treated as a qualified CODA.[175] Similarly, if an employee may choose between an amount of cash and a contribution of an amount in excess of the available cash, any contribution in excess of the

[171] Reg. §1.401(k)-1(a)(3)(i).

[172] The IRS has addressed the effect of a choice between receiving a plan contribution and a non-taxable benefit, such as certain employer-provided health benefits. In general, contributions made under such elections result in taxable income to the employee at the time of contribution. PLR 9513027, PLR 9104050.

[173] Reg. §1.401(k)-1(a)(3)(i), discussed in IX.A., below; CCA 200018001; *cf.* 1986 Conf. Rep., II-405 and 420.

[174] Reg. §1.401(k)-1(e)(2)(i).

[175] Reg. §1.401(k)-1(e)(2)(i).

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amount available in cash is not treated as made pursuant to a qualified CODA.[176]

The IRS has ruled that contributions of the dollar equivalent of unused paid time off to a profit-sharing plan were not elective contributions pursuant to a qualified CODA unless the participant was provided a right to elect to have the dollar equivalent of the unused paid time off paid in cash instead of the contribution.[177] Where the participant was not provided a right to elect payment of such dollar equivalent in lieu of the plan contribution, the IRS ruled that the contribution was not an elective contribution made pursuant to a qualified CODA and should be treated as a nonelective employer contribution. Similarly, the IRS has ruled that a participant's election to cease future participation and benefit accruals in the employer's defined benefit plan in exchange for enhanced employer contributions to the employer's defined contribution plan, without any option to receive cash or some other taxable benefit, was not made pursuant to a qualified CODA.[178]

b. Amount Deferred Under Election Must Not Be Currently Available — Timing of the Election

The requirement in the regulations that a cash or deferred election may only be made with respect to an amount that is not "currently available" to the employee gives rise to several rules regarding the timing of the election. An amount is treated as currently available under the regulations if it has been paid to the employee or if the employee may receive it currently at the employee's discretion.[179] However, an amount is not currently available to an employee if there is a significant limitation or restriction on the right to receive it currently or if under no circumstances may the employee receive the amount before a future date.[180] Whether or not the employee has "constructively received" the amount under §451 is not relevant.[181]

An election can only be made with respect to amounts that would become currently available after the date on which the CODA is adopted or becomes effective, whichever is later.[182]

Practice Insight: This definition of a cash or deferred election requires earlier action on the part of the employer than is the case for other types of qualified plans. By requiring that a CODA be "adopted" by the employer before the deferred amounts are available, the regulations may preclude making a cash or deferred election during a plan year where plan documents are not adopted until the end of the plan year but with an earlier effective date. For plans that do not contain a CODA, board voting and other evidence of plan adoption are often taken late in the year but can become effective earlier in the year.

The election must be made before the contribution occurs in order for the amount to be "not currently available."[183] Thus, a contribution made in anticipation of an employee's election is not made pursuant to a cash or deferred election.

In addition, the contribution must be made after the employee has performed services with respect to which the contributions are made (or when the cash or other taxable benefit would have become currently available, if earlier).[184] Thus, amounts contributed in anticipation of future services generally are not made pursuant to a cash or deferred election. However, 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 will be treated as made pursuant to a cash or deferred election.[185] An exception applies where contributions are occasionally made before the services are performed in order to accommodate bona fide administrative considerations, such as an upcoming vacation of the person responsible for transmitting contributions, so long as the principal purpose is not to accelerate tax deductions.[186]

c. Frequency of the Election

A cash or deferred arrangement must provide employees with an "effective opportunity" to make (or change) a cash or deferred election at least once during each plan year in order for the arrangement to constitute a qualified CODA.[187] Whether an employee has an effective opportunity is determined based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections.[188]

d. Form of the Election

Neither the statute nor the regulations specify any particular form by which a qualified cash or deferred election must be made. As such, plan administrators are free to establish procedural requirements for making an election, including, for example, requiring that a participant make an affirmative investment election as a precondition to an effective salary reduction election. The most common form of a cash or deferred election is a salary reduction agreement, which is an agreement between an employee and the employer that a contribution will be made only if the employee elects to reduce cash compensation or forgo an increase in cash compensation.

In addition, it is clear that a cash or deferred election may be made in an electronic format, such as through a website or by phone or email, provided that the electronic system used to make the election satisfies certain requirements in the regulations regarding content, instructions, accessibility, authentication, review, and confirmation.[189] Electronic elections made in

[176] Reg. §1.401(k)-1(e)(2)(i).

[177] Rev. Rul. 2009-31. *See also* TAM 9635002; PLR 201601012 (annual irrevocable election between having unused paid time off contributed to 401(k) plan or retiree HRA, or a combination of both, with no election to receive payment in cash or other taxable benefit, did not constitute a CODA or pre-tax elective deferrals); PLR 199940043 (contribution of employees' accumulated paid leave to plan was not a cash or deferred election because employees' only options were to take the leave time that would otherwise be forfeited or to receive a plan contribution based on the amount of leave that would be forfeited); PLR 200247050 (similar ruling on exchange of unused sick leave for §401(k) contribution).

[178] PLR 200213029.

[179] Reg. §1.401(k)-1(a)(3)(iv).

[180] Reg. §1.401(k)-1(a)(3)(iv).

[181] *See* Reg. §1.401(k)-1(a)(3)(iv). *Cf.* Reg. §1.451-2(a).

[182] Reg. §1.401(k)-1(a)(3)(iii)(A).

[183] Reg. §1.401(k)-1(a)(3)(iii)(B).

[184] Reg. §1.401(k)-1(a)(3)(iii)(C).

[185] Reg. §1.401(k)-1(a)(3)(iii)(C)(1).

[186] Reg. §1.401(k)-1(a)(3)(iii)(C)(2).

[187] Reg. §1.401(k)-1(e)(2)(ii).

[188] Reg. §1.401(k)-1(e)(2)(ii).

[189] Reg. §1.401(a)-21. The IRS noted in Notice 99-1 that no provision of §401(k), the regulations, or other published guidance thereunder requires a

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accordance with the regulations are treated as having been provided in writing.[190] For a discussion of the rules on using electronic media for participant elections,[191] see 361 T.M., *Reporting and Disclosure Under ERISA*.

e. One-Time Irrevocable Elections

The regulations provide a narrow exception whereby certain elections are not treated as cash or deferred elections. Specifically, the regulations provide that a cash or deferred election does not include a one-time irrevocable election, made no later than the employee's first becoming eligible under any tax-qualified plan of the employer under §401(a), to have contributions made by the employer to the plan equal to a specified amount or percentage of compensation (including no amount of compensation) for the duration of employment, or to receive accruals or other benefits in the case of a defined benefit plan.[192] If the employer also maintains other tax-qualified plans under §401(a), the one-time election must also specify the amount or percentage of compensation to be divided among such other plans. As a result, employer contributions made under this one-time irrevocable election are not treated as having been made pursuant to a CODA and are not includible currently in an employee's gross income as contributions made to a nonqualified CODA.[193]

This exception is typically relied upon by employers who sponsor plans that are not permitted to maintain CODAs in order to offer a certain type of election without disqualifying the plan for impermissibly creating a CODA feature. For example, in the absence of the exception for one-time elections, a waiver of participation in a tax-qualified plan could be deemed to create a CODA a plan that is otherwise ineligible to maintain a CODA.[194]

Practice Insight: The fact that a one-time irrevocable election must be made before the employee's first becoming eligible under any §401(a) plan of the employer, which includes virtually all tax-preferred retirement plans, is often problematic. In this regard, for example, an employer that adds a new plan, such as a plan with a mandatory employee contribution feature, will sometimes want to offer existing employees a one-time irrevocable election to opt out of the plan. The narrow definition of one-time irrevocable election in the regulations, however, means that such a choice would be considered a cash or deferred election with respect to such new plan for any employee who is eligible under an existing plan.

f. Election to Receive or Reinvest ESOP Dividend Distributions

Section 404(k) permits ESOP participants to elect to receive dividend distributions on employer stock held in the plan or to reinvest them in the plan. These elections are not deemed to be attributable to a CODA.[195] In other words, an arrangement offering participants a choice between receiving a §404(k) dividend in cash or deferring its receipt to the plan is not a CODA. As a result, dividend reinvestments are not subject to the limits on contributions under §401(k), §402(g), or §415, and are not taken into account in performing the ADP test.[196]

2. Negative Elections — Automatic Contribution Arrangements

In a traditional §401(k) arrangement, elective deferral contributions are made by a participant affirmatively designating a specific percentage of his or her compensation to be contributed to the plan as part of a salary reduction agreement. However, a qualified CODA may include an arrangement under which the employer automatically reduces the compensation of eligible employees by a default percentage specified in the plan and contributes such amounts to the plan, unless an employee affirmatively elects to receive cash in lieu of the contribution (and not have any contribution made) or elects a different contribution percentage.[197] In such a case, the elective deferral contributed to the trust on the employee's behalf will not fail to be made under a qualified CODA merely because the employee did not make an affirmative election, provided that the employee had an effective opportunity to elect to receive that amount in cash.

Many §401(k) plan sponsors use automatic contribution arrangements as a technique for increasing participation in their §401(k) plans. The underlying theory is that more employees will participate in a §401(k) plan or will participate at a higher level if they do not have to take affirmative action to initiate participation or to designate a specific salary reduction percentage. In turn, because the amount of salary reduction contributions that can be made by a plan sponsor's highly compensated employees is directly related to the average contributions made by all other employees, an increase in participation rates for moderate- and lower-income employees, who are least likely to participate without the automatic contributions arrangement, may also enable highly compensated employees to contribute more by making it easier to pass the ADP test. However, increasing participation rates through an automatic enrollment will typically increase the cost of a plan that has matching contributions.

Automatic contributions arrangements raise additional issues, and ERISA and the Code include several specific provisions to accommodate automatic contribution arrangements. For example, ERISA preemption has been expanded to cover state anti-wage garnishment laws and to create a fiduciary safe harbor from liability for the selection of a type of default investment for automatically enrolled employees. In addition, §401(k)(13) provides a nondiscrimination testing safe harbor for qualified automatic contributions arrangements, which is discussed in detail in IV.C., below, and §414(w) provides a permissible withdrawal right and an extended correction period for excess contributions for eligible automatic contribution arrangements, which are discussed in VII., below.

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cash or deferred election to be made through written paper documents or prohibits making such an election through electronic media.

[190] Reg. §1.401(a)-21(a)(1)(ii)(C).

[191] *See* Reg. §1.401(a)-21.

[192] Reg. §1.401(k)-1(a)(3)(v).

[193] Reg. §1.401(k)-1(a)(3)(v), §1.402(a)-1(d).

[194] PLR 201722014.

[195] Reg. §1.401(k)-1(a)(2)(iii). *See also* Notice 2002-2, Q&A-6.

[196] Notice 2002-2, Q&A-6.

[197] Rev. Rul. 98-30, *amplified and superseded by* Rev. Rul. 2000-8; *see also* Reg. §1.401(k)-1(a)(3)(ii) and Reg. §1.414(w)-1(e)(2).

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a. Overview of Different Automatic Contribution Arrangements

There are three basic types of automatic contribution arrangements that may be included in a qualified CODA. However, automatic contribution arrangements may be designed to qualify as more than one type, depending on the features to be offered and the advantages from which the plan sponsor seeks to benefit.

The first is a general automatic contribution arrangement, which may be included in a CODA simply to provide for the automatic enrollment of eligible employees. Although a general automatic contribution arrangement is not subject to any specific rules, and does not have to comply with the more stringent rules applicable to the other types automatic contribution arrangements, it is also not afforded the same advantages that apply to other types of arrangements.

The second is a qualified automatic contribution arrangement (QACA), which is a type of safe harbor plan described in §401(k)(13) that is treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions (if the safe harbor matching contribution limits are observed and employee after-tax contributions are not permitted).[198] In addition, a QACA that imposes certain contribution limits is not subject to the top-heavy rules of §416.[199] A QACA must also satisfy uniformity, plan year and notice requirements. The requirements applicable to QACAs are discussed in detail in IV.C., below.

The third is an eligible automatic contribution arrangement (EACA), which is a special type of automatic enrollment feature under §414(w) that may be designed to allow eligible employees to withdraw certain contributions to a CODA made shortly after they have been automatically enrolled, and/or to obtain additional time at the end of the plan year to correct excess contributions under the ADP test and excess aggregate contributions under the ACP test. However, an EACA is not a safe harbor plan, so qualification as an EACA does not provide any relief from the ADP or ACP tests or the top-heavy rules of §416. An EACA must also satisfy a uniformity requirement, notice requirements, and a plan year requirement in order to offer either of these features. The requirements applicable to EACAs are discussed in detail in VI., below.

A general automatic contribution arrangement need not be a QACA or an EACA. Rather, an automatic contribution arrangement must meet the requirements applicable to such other arrangements only if the plan is intended to avail itself of the special rules applicable to "qualified" or "eligible" automatic contribution arrangements, which are discussed below in IV.C. and VI., respectively.

b. Design Options for Automatic Contribution Arrangements

The earliest guidance was specific to an arrangement that automatically enrolled newly hired employees in a qualified CODA.[200] Subsequent guidance made clear that automatic enrollment is also permissible for current employees.[201] Further, automatic enrollment may involve any specified rate of default enrollment, provided that the rate does not exceed the §402(g) limit on elective deferrals.[202] Of course, the higher the default enrollment rate, the greater the likelihood that employees will opt out of the program.

Another variation on automatic enrollment involves automatically increasing the rate at which participants contribute, sometimes referred to as automatic escalation.[203] Under an automatic escalation feature, a newly hired participant might be automatically enrolled at a 3% rate and each year thereafter the rate may increase by 1%, so that after year 3 the employee's deferral rate would be 5%. The scheduled increase date in an automatic escalation arrangement (either a default arrangement or one that is affirmatively elected) can be any number of dates including, for example, the first day of the plan year, the anniversary of the employee's first deferral, or even the date upon which the employee receives a pay increase.[204]

Practice Insight: An automatic escalation feature may be used outside the context of automatic enrollment. A plan may, for example, provide employees with the right to affirmatively elect an automatic escalation feature so that an employee's affirmative deferral election increases each year at a specified rate.

The IRS has provided a sample plan amendment that may be used to add an automatic contribution arrangement to a §401(k) plan.[205]

c. Effective Opportunity to Make or Change Deferral Election

In order for an automatic contribution to be made pursuant to a cash or deferred election, the employee must have an effective opportunity to make or change a cash or deferred election at least once during each plan year.[206] This means that the employee must be given the opportunity to opt out of the automatic salary reduction or to choose a different participation rate. Whether an employee has an effective opportunity is determined based on all the facts and circumstances, including the adequacy of the notice of the availability of the election, the period of time during which an election may be made and any other conditions imposed on the election.[207] The most important factor in ensuring that an effective opportunity exists is to provide that a default election may not apply earlier than a reasonable period of time after receipt of the notice describing the automatic contribution arrangement.[208]

Rev. Rul. 2000-8, is the primary authority for structuring general automatic contribution arrangements that satisfy the effective opportunity requirement, as more specific rules apply to QACAs under §401(k)(13) and EACAs under §414(w). In

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[198] §401(k)(13)(A), §401(m)(12).

[199] §416(g)(4)(H).

[200] Rev. Rul. 98-30.

[201] Rev. Rul. 2000-8, *amplifying and superseding* Rev. Rul. 98-30.

[202] General information letter from IRS to J. Mark Iwry, dated March 17, 2004.

[203] Rev. Rul. 2009-30; General information letter from IRS to J. Mark Iwry, dated March 17, 2004. Automatic escalation is a requirement for maintaining a QACA safe harbor plan described in §401(k)(13).

[204] Rev. Rul. 2009-30.

[205] Notice 2009-65.

[206] Reg. §1.401(k)-1(e)(2)(ii).

[207] Reg. §1.401(k)-1(e)(2)(ii).

[208] Reg. §1.414(w)-1(e)(2).

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this ruling, the IRS concluded that newly hired and current employees had an effective opportunity to elect not to make any salary reduction contributions, and that the arrangement complied with the §401(k) requirements, where[209] (1) the plan provided for a salary reduction contribution of 3% for all new hires and current employees who had not elected compensation reduction contributions of at least 3%, unless they affirmatively elected not to make such a contribution or designated a different salary reduction percentage; (2) employees received a notice a reasonable period before the effective date of the automatic salary reduction contribution that explained how it worked and that informed them of their right to elect not to make salary reduction contributions or to alter the amount of the salary reduction contributions at any time; and (3) all employees were notified annually of their salary reduction percentages (if any) and their right to modify their elections at any time.

Practice Insight: The question of whether employees have been provided an effective opportunity to make an election typically arises in plans that provide for immediate eligibility upon hire because the first payroll date following hire may provide very little time for an employee to make a considered participation election. To address this issue, plans that provide for immediate eligibility upon hire will sometimes delay the timing of automatic enrollment for a reasonable period to ensure that employees have an effective opportunity to opt out of the arrangement or to make an affirmative election. For example, a plan may provide for immediate eligibility but provide that any employee that has not made an affirmative election within 30 days of hire will be automatically enrolled in the plan effective as of the next subsequent pay date. In this regard, as a general matter, there is no requirement that automatic enrollment occur on the first date that an employee is eligible to make an affirmative election to participate.

It is also permissible to "refresh" prior elections.[210] For example, a plan may provide that any employee who is not currently participating in the CODA will be automatically enrolled at a specified rate unless the employee affirmatively opts out. Under this approach, the mere fact that an employee affirmatively elected not to participate at one time would not mean that the participant would never be automatically enrolled. Instead, the plan would put the onus on the employee of affirmatively electing out of the plan periodically. There are a number of techniques that may be used to refresh elections; for example, a plan may provide that an employee's affirmative election not to participate will only be effective for one year and that the employee must affirmatively opt out of participation each year or he or she will be automatically enrolled at a specified rate. Thus, automatic contribution arrangements highlight how affirmative elections can be designed to be limited in scope and duration such that they remain in place for a more prescribed period of time, rather than indefinitely.

[209] Rev. Rul. 2000-8.

[210] T.D. 9447, 74 Fed. Reg. 8200, 8202–03 (Feb. 24, 2009) (preamble to final automatic contribution regulations); *see also* Reg. §1.414(w)-1(e)(3), discussing a plan that provides for a default election when an employee's prior affirmative election no longer remains in effect.

d. State Anti-Wage Garnishment Laws

One issue that can arise with respect to an automatic contribution arrangement is the impact of state anti-wage garnishment laws, which generally prohibit an employer from taking amounts out of an employee's compensation without the employee's consent. Consent clearly exists where an employee makes an affirmative election to contribute to a qualified CODA, but whether the requisite consent exists when an employee is automatically enrolled may be problematic under state anti-wage garnishment laws.[211]

Section 514(e)(1) of ERISA addresses this issue by explicitly providing that ERISA preempts any state law that would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement.[212] ERISA §514(e) defines an "automatic contribution arrangement" as a CODA under which the employee is treated as having elected to have the employer contribution in an amount equal to a uniform percentage of compensation until the participant specifically elects not to have such contributions made (or specifically elects to have such contributions made at a different percentage) and under which the contributions are invested in a qualified default investment alternative under ERISA §404(c)(5). Nonetheless, the Department of Labor (DOL) has provided broader relief with regulations specifically providing that ERISA §514(e) preempts any state law that would restrict the use of an automatic contribution arrangement, including an arrangement that invests defaulted participants in investments that are not qualified default investment alternatives.[213]

Practice Insight: Plans that are not subject to ERISA, such as governmental plans that are grandfathered under §401(k)(4)(B), do not get the benefit of ERISA's broad preemption of state anti-wage garnishment laws. Some but not all state laws have been updated to allow for automatic enrollment but a careful review of the applicable state law is necessary in such instances.

[211] *See, e.g.*, EBSA Information Letter to Julie A. Spiezio, 2018 BL 497227 (Dec. 4, 2018) (in response to question on application of ERISA §514(a) to state civil laws requiring written consent prior to employer withholding from employee wages via automatic enrollment arrangement for ERISA-covered disability benefit plans, DOL reaffirmed its view that state laws similar to those referenced in DOL Advisory Opinion 96-01A and DOL Adv. Op. 93-05A (Puerto Rico law), DOL Adv. Op. 94-27A (New York law), and DOL Adv. Op. 2008-02A (Kentucky law), would generally be preempted by ERISA §514(a), to the extent the law interferes with an employer's implementation of an automatic enrollment arrangement in connection with a disability or other welfare benefit plan covered under Title I of ERISA).

[212] Prior to the enactment of the 2006 PPA, there was some question as to where ERISA preempted state anti-garnishment laws. ERISA generally supersedes or preempts any state laws that "relate to" an employee benefit plan, including a qualified CODA. ERISA §514(a). However, ERISA preemption did not apply to any generally applicable criminal law of a state, and state anti-wage garnishment laws were criminal statutes in certain states. ERISA §514(b)(4).

[213] 29 C.F.R. §2550.404c-5(f). Effective December 18, 2015, a church plan under §414(e) may have an automatic contribution arrangement and, if certain requirements are met, that arrangement is not preempted by any state law relating to wage, salary or payroll payment, collection, deduction, garnishment, assignment, or withholding that would directly or indirectly prohibit or restrict the inclusion of the automatic contribution arrangement in the plan. Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §336(c)(1). For further discussion of automatic contribution arrangements for church plans, see 372 T.M., *Church and Governmental Plans.*

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e. Investment Considerations

The fiduciaries of a §401(k) plan are responsible for the investment of plan assets. Section 404(c) of ERISA, however, relieves fiduciaries from liability when participants or beneficiaries exercise control over the investment of assets in their individual accounts.[214] In part because of this fiduciary relief, and partly because employees tend to view amounts that they contribute to a §401(k) plan from a more proprietary perspective, most §401(k) plans provide that the participant has the right to direct the investment of his or her account balance among a menu of investment options. Although the issue of how to invest contributions where a participant does not make an affirmative investment election is not exclusive to automatic contribution arrangements, the issue is more likely to arise in such a case, because a participant who has not made an affirmative deferral election probably will also fail to make an affirmative investment election.[215] Thus, employers considering whether to implement an automatic contribution arrangement are often concerned about liability for the investment of default contributions.

In contrast to the IRS, which generally treats an elective deferral as the result of a negative election in the same manner as an elective deferral as a result of an affirmative election, the Department of Labor differentiates between affirmative and negative investment elections. The DOL takes the position that a participant or beneficiary will not be considered to have exercised control when he or she is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary.[216] As such, even a participant who received notice within a reasonable period before the effective date of an automatic salary reduction contribution, which explained how the arrangement worked and informed the participant of the default investment in the absence of an affirmative election, is not treated as exercising effective control over the investment of their account balances. Thus, absent an exception, the employer remains liable for the investment of default contributions under the automatic contribution arrangement.

This interpretation provided to be a significant barrier to the widespread adoption of automatic contribution arrangements and, in response, Congress enacted ERISA §404(c)(5) to provide relief.[217] ERISA §404(c)(5) provides that a participant will be treated as making an affirmative investment election if the plan invests in accordance with DOL regulations, which prescribe a variety of requirements, including, among others, notice and investment requirements.[218] This provision effectively extends the limited fiduciary relief for participant-directed investment decisions in ERISA §404(c) to default investments. These regulations are discussed in detail in 365 T.M., *ERISA — Fiduciary Responsibility and Prohibited Transactions.*

3. Compensation Eligible for Deferral Elections Under a Qualified CODA

A qualified CODA may only permit elective deferrals to be made from the types of compensation that are described under §415(c)(3) and Reg. §1.415(c)-2, which is the same I.R.C. section that imposes the overall, annual limit on contributions that can be made to a qualified plan.[219] Section 415 compensation generally includes wages, salaries, fees for professional services, and other amounts received for personal services actually rendered in the course of employment with the employer maintaining the plan, to the extent the amounts are includible in income (or would have been includible in income but for a cash or deferred election).[220] Thus, even if the total amount of elective deferrals, nonelective employer contributions, matching contributions, and after-tax employee contributions (and allocations of forfeitures) is not at issue under §415 for the year, the compensation with respect to which the employee's deferral election is made must be §415 compensation (apparently without regard to the plan's definition of §415 compensation, such as a simplified or safe harbor definition).

Practice Insight: One of the more common operational errors involving a qualified CODA is failing to correctly apply the plan's definition of compensation. If, for example, a plan provides that the definition of compensation for purposes of salary reduction elections includes commissions and a participant elects to defer 10% of compensation, the amount contributed should include 10% of the commissions payable to the employee. The IRS correction method for a failure to properly implement such an election is onerous with the employer generally obligated to make a corrective contribution equal to 50% of the missed deferral plus earnings even though the employee received the cash compensation.[221]

a. Bonuses and Other Permitted Compensation

The §415(c)(3) definition of compensation allows qualified CODAs to offer employees the opportunity to defer regular cash compensation, as well as other types of compensation, such as bonuses and paid time off. As such, an arrangement that allows for the deferral of all or part of a formula or discretionary bonus may also constitute a qualified CODA. Under the current availability rules discussed in II.B.1.b., above, an employee may decide to defer a bonus into the CODA at any time before the date fixed for payment of the bonus, even though the bonus has been earned and is being paid in respect of services for a prior period.[222]

Similarly, a CODA may involve deferrals of commissions and other items of irregular compensation. Compensation received in lieu of unused time off for vacation or sick leave, or in lieu of overtime pay, are examples of irregular compensation

[214] It is, of course, not as simple as it sounds. Department of Labor (DOL) regulations somewhat narrowly define the circumstances in which a participant will be treated as exercising control over assets in his or her account. 29 C.F.R. §2550.404c-1.

[215] The issue may arise, for example, if an investment option in the plan is eliminated or if the plan provides for nonelective employer contributions.

[216] Rev. Rul. 2000-8, n.1, indicating that the DOL informed the IRS of its position that a negative investment election will not be considered investment control for purposes of ERISA §404(c).

[217] ERISA §404(c)(5), added by 2006 PPA, Pub. L. No. 109-280, §624(a), and amended by Pub. L. No. 110-458, §106(d), effective for plan years beginning after 2006.

[218] 29 C.F.R. §2550.404c-5.

[219] Reg. §1.401(k)-1(e)(8), effective for compensation that is paid (or would have been paid but for a cash or deferred election) in plan years beginning on or after July 1, 2007.

[220] Reg. §1.415(c)-2(b).

[221] *See* Rev. Proc. 2021-30, app. A, §.05(5). For discussion of EPCRS, see 375 T.M., *EPCRS — Plan Correction and Disqualification.*

[222] Reg. §1.401(k)-1(a)(3)(iv), §1.401(k)-1(a)(3)(vii) *Ex.* 1.

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that may be deferred under a qualified CODA. For example, an employer may limit vacation carry-forwards and cash out unused vacation following the year in which it is earned. An employer may make such compensation eligible for deferral under the CODA, or provide that unused paid time off is automatically contributed to a qualified plan.[223] However, if there is no cash option, the arrangement is not considered a qualified CODA, as discussed above in II.B.1.a., and the contributions will be treated as nonelective employer contributions.

Practice Insight: Arrangements providing for the automatic contribution of unused paid time off are common for governmental employers but the §401(a)(4) nondiscrimination rules generally make such arrangements impractical for nongovernmental plans unless the plan is collectively bargained.

b. Post-Severance Compensation

Certain items of compensation are not considered §415 compensation[224] and, as a result, a qualified CODA may not permit cash or deferred elections with respect to such pay. The most notable of these items is compensation paid after severance from employment with the employer maintaining the plan.[225] Although the general rule is that compensation paid after severance from employment is not eligible compensation, the regulations include two significant exceptions.

First, compensation that is paid after severance from employment but that would have been paid to the employee had the employee continued to work is eligible compensation, provided that it is paid by the later of 2½ months after severance from employment or the end of the limitation year that includes the date of the employee's severance from employment.[226] As a result, for example, the mere fact that an employee's final paycheck is not issued until a few weeks after severance from employment does not taint the compensation. The employee may still make a qualified cash or deferred election with respect to such compensation.

Second, a cash or deferred election may be made with respect to payments for unused accrued bona fide sick, vacation, or other leave if the employee would have been able to use such leave if he or she continued in employment and if such amounts are paid by the later of 2½ months after severance from employment or the end of the limitation year in which the severance occurred.[227] Thus, a participant may be offered a cash or deferred election with respect to a typical leave cash-out program under which unused leave at termination of employment is cashed out.

The principal effect of this rule is to provide that elective deferrals may not be made out of severance payments paid after severance from employment. The rule, however, does create an odd distinction that depends on the timing of the payment. For example, it appears that a cash or deferred election may be offered with respect to severance that is paid to the employee on the last day of employment but not thereafter. This distinction obviously places significant pressure on identifying an employee's last day of employment and suggests, for example, that a terminal leave program, under which an employee is kept on the payroll for a period following the last day on which the employee renders services may not offer qualified cash or deferred elections.

The §415 regulations explicitly permit cash or deferred elections to be made with respect to amounts paid under a nonqualified deferred compensation plan, provided that such compensation would have been paid to the employee if he or she had continued working and such amounts are paid within the time frame mentioned above for leave cash-outs and ongoing compensation.[228] For example, nonqualified deferred compensation that is payable on a fixed date that falls within the relevant time period is considered §415 compensation and potentially eligible for a cash or deferred election. However, nonqualified deferred compensation that is payable as a result of severance from employment appears to be ineligible for a cash or deferred election.

4. Meaning of "Trust" for Purposes of Election

Section 401(k)(2)(A) requires that the amounts subject to the employee's election be contributed by the employer to a trust. Although most profit-sharing and stock bonus plans include trusts to which contributions are made, some provide only for contributions to a custodial account or an annuity or other insurance contract. Section 401(f) provides that an annuity or other insurance contract is to be treated as a qualified trust under §401 if it otherwise meets the requirements of a qualified trust, as long as it is not a life, health or accident, property, casualty, or liability insurance contract. Section 401(f) provides the same treatment for a custodial account meeting the requirements of a qualified trust, as long as it is held by a bank or other person who demonstrates to the satisfaction of the Treasury Secretary or his delegate that such person will hold the assets in a manner consistent with the requirements of §401. Because §401(f) treats a qualifying custodial account or insurance contract as a trust for all purposes of §401, the reference to "trust" in §401(k) includes such a custodial account or insurance contract.

5. Elections by Self-Employed Individuals

A self-employed individual who has "earned income" is treated for all purposes of §401 as if the individual were an employee.[229] Thus, a qualified CODA (i.e., a 401(k) plan) may be maintained by a sole proprietorship or an entity that is treated as a partnership for tax purposes (e.g., limited liability company, limited partnership, or general partnership), as well as an S corporation or C corporation, and may allow the sole proprietor or self-employed partners or shareholders, as well as common law employees, to make cash or deferred elections.[230] Earned income is net earnings from self-employment (as defined under §1402(a) but subject to certain modifications under §401(c)) with respect to a trade or business in which the personal services of the taxpayer are a material income-producing factor. The individual may only make a cash or deferred election with respect to compensation, or earned income, that is attributable to services rendered to the entity. This precludes owners of

[223] Rev. Rul. 2009-31, Rev. Rul. 2009-32. *See, e.g.*, PLR 201601012.
[224] Reg. §1.415(c)-2(c).
[225] Reg. §1.415(c)-2(e)(1)(ii).
[226] Reg. §1.415(c)-2(e)(3)(ii).
[227] Reg. §1.415(c)-2(e)(3)(iii).
[228] Reg. §1.415(c)-2(e)(3)(iii)(B).
[229] §401(c)(1).
[230] Reg. §1.401(k)-1(a)(6)(i).

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partnerships and S corporations who are passive investors from being treated as employees and, therefore, from being able to contribute to a qualified CODA.

In addition, a special timing rule applies to payments made to a self-employed individual such that a partner's compensation is deemed to be currently available on the last day of the partnership's tax year and a sole proprietor's compensation is deemed to be currently available on the last day of the individual's tax year.[231] Thus, a partner or sole proprietor must make a cash or deferred election with respect to compensation for a tax year before the last day of the partnership's tax year or the individual's tax year, as applicable.[232] If a self-employed individual receives advance payments during the tax year (e.g., partnership draws), a qualified CODA may permit a deferral election and contribution to be made with respect to the advance payments, even though this results in the contribution being made before the amount of the individual's earned income for the tax year is finally determined and reported.[233] However, the advance payments cannot not exceed a reasonable estimate of the individual's earned income for the tax year.[234] On the other hand, the fact that a partner or sole proprietor receives advance payments during the year will not preclude the individual from making an election with respect to such payments on the last day of the partnership's or individual's tax year, as applicable, because they are not deemed to be currently available before such date. Regardless of when elective deferrals made on behalf of a partner or sole proprietor are contributed to the plan, they are not deemed to be allocated to the individual's plan account until the last day of the partnership's or sole proprietor's tax year, as applicable.[235] Otherwise, the same qualification rules of §401(k) apply to the elections of self-employed individuals who participate in CODAs maintained by sole proprietors, partnerships, and S corporations that apply to elections made by employees.

Practice Insight: Although the special timing rule provides some flexibility in that partners and sole proprietors may wait until the end of the tax year to make cash or deferred elections, some partnerships and sole proprietorships do not determine the individual's amount of earned income for the tax year until the partnership's or individual's income tax return is filed. At that point, it will be too late to make a cash or deferred election for the tax year. Earned income must be determined before the end of the tax year, well in advance of the due date of the tax return on which it is reported, to allow for individuals to maximize their elective deferral contributions.

Whether a cash or deferred arrangement exists, or a contribution is an employee elective deferral or a nonelective contribution, is often difficult to determine in the context of a sole proprietorship or a partnership. The regulations provide that in the case of a partnership, a CODA "includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf."[236] In this regard, a sole proprietor can easily vary the amount of contributions that are made to a profit-sharing plan on his or her behalf, because the sole proprietor is the only party that can make and benefit from decisions about the nature of the contributions. It is often more straightforward for a sole proprietor to structure the plan to be a discretionary profit-sharing plan that involves employer nonelective contributions, but such a plan which will essentially function as the equivalent of a CODA with elective deferrals because the employer making the contribution decision is the sole proprietor. Thus, the distinction between elective deferrals and nonelective contributions, and whether a CODA exists, is not particularly meaningful in the context of a sole proprietorship. However, a sole proprietor may want the profit-sharing plan to include a CODA feature to allow the proprietor to make catch-up contributions under §414(v) and, therefore, effectively increase his or her §415 limit.

Similarly, the fact that each of the partners in a partnership often has a significant say in the extent to which contributions are made to a profit-sharing plan results in the partners being able to vary the amount of contributions made on their behalf (e.g., the cost of benefits are typically allocated to each partner in determining their distributive share of partnership income). This alone should not cause contributions that are made on behalf of the partner to be considered as made pursuant to a CODA if the partner does not have an election to receive cash in lieu of the contribution. In addition, the mere fact that different rates of employer nonelective contributions are made on behalf of some partners, and the partners have a say in the contribution structure, should not cause the contributions to be considered made pursuant to a cash or deferred election in the absence of an election to receive cash in lieu of the contribution. However, at some point in the continuum, it seems apparent that too much control on the part of the individual partners would cause the contributions to be considered as made under a CODA, in which case the rules of §401(k) must be applied.[237] That particular partners may be exercising too much control can become apparent where the plan includes frequent amendments affecting the contribution or accrual rate for particular partners, as increases in contribution rates will generally reduce partner take-home pay and decreases in contribution or accrual rates will increase take-home pay.

C. Distributions of Elective Contributions From CODA Must Be Restricted to Permissible Events: §401(k)(2)(B)

Section 401(k)(2)(B) limits the circumstances under which elective contributions may be distributed from the CODA to certain specified events. The purpose of these limitations

[231] Reg. §1.401(k)-1(a)(6)(iii).

[232] Reg. §1.401(k)-1(a)(6)(iii). For plan years beginning before 1992, elections were permitted up until the due date (including extensions) for filing the partnership's federal income tax return.

[233] Reg. §1.401(k)-1(a)(6)(iv); PLR 200247052.

[234] Reg. §1.401(k)-1(a)(6)(iv).

[235] Reg. §1.401(k)-2(a)(4)(ii).

[236] Reg. §1.401(k)-1(a)(6)(i). For special transition rules and rules dealing with a partner's one-time irrevocable election to participate in a plan, see Rev. Proc. 91-47 and Notice 88-127, as modified.

[237] Reg. §1.401(k)-1(a)(6)(i) ("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."). *See* PLR 200247052 (contributions to partnership's §401(k) plan made by periodic advances received by partner throughout year at partner's election are elective contributions because partner can elect for partnership to contribute an amount to plan rather than receive an amount in cash and such amount is not currently available under former Reg. §1.401(k)-1(a)(6)(ii)(B) (later replaced by Reg. §1.401(k)-1(a)(6)(iii))).

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is the same as for all tax-qualified plans, which is to promote saving for retirement, yet each type of tax-qualified plan has its own rules regarding when distributions can be made. The most notable differences in this regard are that there are more restrictions on in-service withdrawals of elective deferrals made under a qualified CODA than for other types of plans or for contributions, such as nonelective employer contributions held in a profit-sharing plan. For example, plans holding elective deferrals made under a qualified CODA cannot be designed to allow for a distribution of such amounts based upon an employee's mere participation in the plan for a fixed number of years or the attainment of any age earlier than 59½ without a separation from service. However, plans with a CODA may include provisions that allow for in-service hardship distributions of elective deferrals, qualified nonelective employer contributions, qualified matching contributions and certain safe harbor contributions.

In addition to §401(k)(2)(B), there are additional distribution events permissible under the regulations and other provisions of the Code. For additional discussion of the distribution rules applicable to qualified CODAs under §401(k)(2)(B), including distribution rules applicable to other types of tax-qualified retirement plans, see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification.*

1. Permissible Distribution Events Under §401(k)(2)(B)

Section 401(k)(2)(B)(i) provides that amounts held by a plan that are attributable to "employer contributions" under a qualified CODA may not be distributed to participants or beneficiaries before one of the following events occurs with respect to the employee (or the plan):

- death;
- disability;
- severance from employment;
- hardship;[238]
- attainment of age 59½;[239]
- upon orders or call to active military duty in the case of a "qualified reservist distribution" (as defined in §72(t)(2)(G)(iii));
- termination of the plan;
- 90 days prior to the date that a "lifetime income investment" (as defined in §401(a)(38)(B)(ii)) may no longer be held as an investment option under the arrangement with respect to amounts invested in a lifetime income investment termination; or
- payment of premiums for long-term care insurance (effective for distributions made after December 29, 2025).[240]

Each of these distribution events is discussed in see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification.*

Section 401(k)(2)(B)(ii) and the regulations reinforce the restriction that contributions made to a qualified CODA may not be distributed until the occurrence of one of the above events by providing that amounts attributable to employer contributions under a qualified CODA cannot be distributed merely by reason of completing a stated participation period or the lapse of a fixed number of years and that the circumstances described in Reg. §1.401(k)-1(d) constitute the "exclusive distribution rules" with respect to elective contributions.[241] This rule is meant to distinguish elective contributions from other types of contributions, which are subject to fewer restrictions on when they may be distributed from a profit-sharing plan. In general, the definition of a profit-sharing plan in the regulations allows amounts attributable to contributions other than elective deferrals to be distributed after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event such as layoff, illness, disability, retirement, death, or severance of employment.[242] Rulings from the IRS have interpreted this to mean that a plan may allow amounts that are not attributable to elective deferrals to be distributed after they have remained in the plan for at least two years or the employee has participated in the in the plan for at least five years.[243]

Practice Insight: A 401(k) plan may be designed to allow for the earlier distribution of amounts attributable to profit-sharing contributions (i.e., amounts that are not attributable to elective deferrals), but this requires separate accounting for the different types of contributions under the plan to determine the amounts available when making distributions. However, if the distribution does not occur in accordance with one of the events described in §72(t), the additional 10% tax on early distributions may apply, even though a permissible distribution event has otherwise occurred.

2. Other Permissible Distribution Events

In addition to the distribution events listed under §401(k)(2)(B), the regulations under §401(k) and other sections of the Code create additional distribution events that are permissible with respect to amounts attributable to elective contributions under a qualified CODA. These include:

- Disaster-related relief;
- Qualified birth or adoption;[244]
- Default of plan loans;[245]

[238] Distributions may not be made upon hardship in the case of a pre-ERISA money purchase pension plan with a CODA. §401(k)(2)(B); Reg. §1.401(k)-1(d)(1). However, all other distribution events in §401(k)(2)(B)(i) still apply.

[239] Distributions may not be made upon attainment of age 59½ in the case of a pre-ERISA money purchase pension plan with a CODA. §401(k)(2)(B); Reg. §1.401(k)-1(d)(1). However, all other distribution events in §401(k)(2)(B)(i) still apply.

[240] *See* §401(a)(39), added by Pub. L. No. 117-328, Div. T, §334(a), effective for distributions made after December 29, 2025; §401(k)(2)(B)(i)(VII), added by Pub. L. No. 117-328, Div. T, §334(b)(1), effective for distributions made after December 29, 2025.

[241] *See* Reg. §1.401(k)-1(d)(5)(i).

[242] Reg. §1.401-1(b)(1)(ii).

[243] Rev. Rul. 54-231, Rev. Rul. 68-24, Rev. Rul. 71-295. These rulings are based on the definition of a profit-sharing plan in Reg. §1.401-1(b)(1)(ii), which generally allows for the funds accumulated under the plan to be distributed after a fixed number of years.

[244] Pub. L. No. 116-94, Div. O, §113(a) (adding §72(t)(2)(H)(vi)(IV)).

[245] Reg. §1.401(k)-1(d)(5)(ii).

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- Unwinding of eligible automatic contribution arrangements;[246]
- Corrections of excess contributions under the ADP test;[247]
- Corrections of excess deferrals under §402(g) annual limits;[248]
- Qualified domestic relations orders (QDROs);[249]
- ESOP dividend distributions;[250]
- Deemed severance for military service under §414(u)(12)(B);
- Military death benefits under §401(a)(37);
- Coronavirus-related distributions;[251]
- Private sector firefighters separated from service after age 50 or 25 years of service under the plan, whichever is earlier;[252] and
- Eligible distributions to domestic abuse victims.[253]

3. *Types of Contributions Subject to §401(k)(2)(B) Distribution Restrictions*

a. *Nonelective Employer Contributions and Matching Contributions*

The restrictions under §401(k)(2)(B) that limit distributions to the foregoing events do apply to nonelective employer and matching contributions if they are to be combined with the elective contributions to satisfy the 1.25 or 2.0 ratios under the ADP test of §401(k)(3). Nonelective contributions (including matching contributions) that are not combined with elective contributions for this purpose are not subject to §401(k)(2)(B).

b. *Rollover Contributions*

Section 401(k)(2)(B) continues to apply in the transferee plan to amounts attributable to elective contributions (including any QNECs or QMACs taken into account for ADP testing purposes) that are transferred to another qualified plan of the same or a different employer (i.e., in a trustee-to-trustee transfer or a merger of two CODAs), unless the transfer is an eligible rollover distribution made as a direct trustee-to-trustee transfer under §401(a)(31), a voluntary transfer of otherwise distributable amounts under Reg. §1.411(d)-4, Q&A-3(b)(1), or could have otherwise been made under a permissible distribution event in §401(k)(2)(B).[254] A CODA will fail to be a qualified CODA if it distributes amounts attributable to elective deferrals to another plan that does not impose the distribution restrictions of §401(k)(2)(B) and the regulations thereunder.[255] Likewise, the transferee plan will generally fail to satisfy the requirements of §401(a) (and the regulations on the distribution restrictions of §401(k)(2)(B)) if it allows amounts transferred to it to be distributed before one of the events under §401(k)(2)(B) or the regulations thereunder occurs.[256]

The §401(k)(2)(B) restrictions do not apply to after-tax employee contributions or amounts that were "eligible rollover distributions" to the plan under §402(c) or §408(d)(3)(A).[257] This is true even if the amounts rolled over were distributed from another qualified CODA, because they would have already satisfied the distribution rules of §401(k)(2)(B) to be eligible for distribution as this type of a rollover.

c. *ESOP Dividends*

In general, a plan may either pay dividends on employer securities of a C corporation held by an ESOP, including an ESOP with a qualified CODA, in cash or offer participants an election to have the dividend paid in cash or reinvested in the ESOP.[258] Reinvested dividends are treated in the same manner as investment earnings such that the character and rules that apply to a §404(k) dividend that is reinvested in the plan depend on the source of the dividend.[259] If the dividend is payable on stock held in the portion of the plan that is a §401(k) plan, then the amount attributable to the reinvested dividend is subject to all of the rules that apply to a qualified CODA, including the §401(k)(2)(B) distribution restrictions.[260]

4. *Timing and Form of Distributions*

Once an event occurs which permits distribution of benefits under §401(k)(2)(B), those distributions are subject to the general requirements for qualified pension, profit-sharing, and stock bonus plans relating to the form and time in which distributions may or are required to be made.[261]

5. *Separate Accounting Requirement*

Under Reg. §1.401(k)-1(e)(3)(i), all amounts treated as attributable to elective contributions which must satisfy the distribution limitations of §401(k)(2)(B) must be identified by an acceptable separate accounting between such portion and 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 that are subject to the distribution restrictions and to other accounts under the plan. As an alternative, the separate accounting requirement is deemed to be satisfied without actual separate accounting if all amounts held under the plan that includes the qualified CODA (and any other plan from which contributions are taken into account for purposes of the nondiscrimina-

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[246] §414(w); Reg. §1.414(w)-1.
[247] §401(k)(8).
[248] Reg. §1.402(g)-1.
[249] §401(a)(13).
[250] Reg. §1.401(k)-1(d)(5)(iii).
[251] Pub. L. No. 116-136, §2202.
[252] §72(t)(10)(A), as amended by Pub. L. No. 117-328, Div. T, §308(a), §329(a), effective for distributions made after December 29, 2022.
[253] §72(t)(2)(K), added by Pub. L. No. 117-328, Div. T, §314(a), effective for distributions made after December 31, 2023.
[254] Reg. §1.401(k)-1(d)(5)(iv).
[255] Reg. §1.401(k)-1(d)(5)(iv).
[256] Reg. §1.401(k)-1(d)(5)(iv).
[257] Rev. Rul. 2004-12. An amount rolled over to a designated Roth account pursuant to §402A(c)(4)(E) remains subject to the distribution restrictions that were applicable to the amount before the in-plan Roth rollover. Notice 2013-74, Q&A-3.
[258] §404(k)(2)(A).
[259] Notice 2002-2, Q&A-7.
[260] Notice 2002-2, Q&A-7.
[261] *See* 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification.*

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tion test) are subject to the §401(k)(2)(B) distribution restrictions.[262]

D. *Elective Contributions Must Be Nonforfeitable: §401(k)(2)(C)*

Section 401(k)(2)(C) provides that a qualified CODA must require that an employee's right to his accrued benefit derived from employer contributions made to the trust pursuant to his election is nonforfeitable. This means that the employee may never forfeit for any reason the elective contributions made for his or her benefit, or the investment return attributable thereto, and that such amounts are fully vested at all times.[263] The rationale for this rule is that the employee's elective deferrals represent money that otherwise would have been currently payable to him or her in cash and, therefore, should never be subject to forfeiture or a vesting schedule.

The same nonforfeitability requirement applies to any qualified matching or qualified nonelective employer contributions (i.e., QMACs or QNECs) that are to be combined with the elective contributions to satisfy the ADP test of §401(k)(3).[264] See III.H.2., below. In contrast, employer matching contributions and nonelective employer contributions that are not combined with elective contributions to satisfy the nondiscrimination tests may be subject to any vesting schedule permitted under §411(a)(2)(b).[265]

The regulations expand on the nonforfeitability requirement, providing that amounts attributable to an employee's elective contributions must (1) be "immediately nonforfeitable"; (2) be disregarded for purposes of applying the minimum vesting standards of §411(a)(2) to other contributions or benefits; and (3) remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.[266] Each of these requirements is discussed below.

1. *Elective Contributions Must Be Immediately Nonforfeitable*

An amount is immediately nonforfeitable if it is immediately nonforfeitable within the meaning of §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.[267] Section 411(a)(1) contains a corresponding rule, providing that a plan satisfies the minimum vesting standards of §411(a), which is required for tax qualification under §401(a)(7), if an employee's rights in his or her accrued benefit derived from his or her own contributions are nonforfeitable.

In addition, an amount will not be immediately nonforfeitable if it is subject to the special forfeitures or suspensions permitted by §411(a)(3). Section 411(a)(3) provides several narrow exceptions to the general vesting requirements of §411, such as rules allowing certain benefits that are forfeitable upon death, and upon other technical forfeiture situations that are more common under defined benefit plans, to be treated as fully vested. Thus, none of the forfeitures permitted by §411(a)(3) are permitted with respect to amounts attributable to elective contributions under a qualified CODA.[268]

A special rule applies for purposes of determining whether a long-term, part-time employee who is eligible to participate in a CODA has a nonforfeitable right to employer contributions within the meaning of §401(k)(2)(C). In such cases, each 12-month period for which the employee has at least 500 hours of service shall be treated as a year of service, and §411(a)(6) shall be applied by substituting "at least 500 hours of service" for "more than 500 hours of service" in §411(a)(6)(A).[269]

2. *Disregarding Elective Contributions in Applying §411(a) Vesting Rules to Other Plan Contributions*

To be nonforfeitable, elective contributions must also be disregarded when applying the vesting requirements of §411(a)(2) to other contributions or benefits.[270] Thus, in a plan that contains a qualified CODA, the vesting schedules normally available for employer contributions can be applied only as to those contributions, if any, other than the elective contributions under the CODA, and the vesting requirements must be satisfied without taking into account such elective contributions.

> *Example:* An employer maintains a profit-sharing plan under which nonelective contributions are made by the employer, in addition to elective contributions under a CODA. Under §411(a)(2), an employee, in a particular year, is required to have at least a 40% vested interest in his accrued benefit derived from employer contributions under the plan. More than 40% of the total amounts credited to the employee's accounts under the plan are attributable to elective contributions required to be nonforfeitable under §401(k), and therefore more than 40% of the employee's interest in the plan as a whole is vested. This 40% vested interest in the plan as a whole, however, is not sufficient to satisfy §411(a)(2). The employee must have at least a 40% vested interest in his account balance attributable to the nonelective employer contributions as well as a 100% vested interest in his account balance attributable to elective contributions.

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262 Reg. §1.401(k)-1(e)(3)(ii).

263 Reg. §1.401(k)-1(c)(2).

264 §401(k)(3)(C), §401(k)(3)(D); Reg. §1.401(k)-2(a)(6), §1.401(k)-6.

265 Effective for contributions for plan years beginning after December 31, 2001, employer matching contributions were required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules:(1) the participant acquires a nonforfeitable right to 100% of employer matching contributions upon the completion of three years of service; or (2) the participant has a nonforfeitable right to 20% of employer matching contributions for each year of service beginning with the participant's second year of service. Former §411(a)(12), added by EGTRRA. Pub. L. No. 107-16, §633(a)(2), and repealed by 2006 PPA, Pub. L. No. 109-280, §904(b)(2). Effective for plan years beginning after 2007, this rule was extended to all employer contributions to a defined contribution plan, including nonelective employer contributions. §411(a)(2) and ERISA §203(a)(2), as amended by Pub. L. No. 109-280, §904(a)(1) and §904(b)(1), respectively.

266 Reg. §1.401(k)-1(c)(1).

267 Reg. §1.401(k)-1(c)(2).

268 Reg. §1.401(k)-1(c)(2).

269 §401(k)(15)(B)(iii). *See* Prop. Reg. §1.401(k)-5(d)(1)(i), REG-104194-23, 88 Fed. Reg. 82,796 (Nov. 27, 2023).

270 Reg. §1.401(k)-1(c)(1).

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3. Continuing Nonforfeitability

Under Reg. §1.401(k)-1(c)(1), elective contributions must remain nonforfeitable, even if the employee makes no additional elective contributions under a CODA.

4. Separate Accounting Requirement

Under Reg. §1.401(k)-1(e)(3)(i), all amounts treated as attributable to elective contributions which must satisfy the nonforfeitability requirement of §401(k)(2)(C) must be identified by an acceptable separate accounting between such portion and 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 that are subject to the nonforfeitability requirement and to other accounts under the plan. As an alternative, the separate accounting requirement is deemed to be satisfied without actual separate accounting if all amounts held under the plan that includes the qualified CODA (and any other plan from which contributions are taken into account for purposes of the nondiscrimination test) are subject to the nonforfeitability requirement of §401(k)(2)(C).[271]

E. Years of Service Requirement for Participation Must Be Limited: §401(k)(2)(D)

Section 401(k)(2)(D) provides that a CODA will not be a qualified CODA if the plan requires that employees satisfy eligibility criteria that exceed certain maximum age and period of service limits before they are permitted to make elective deferrals. However, a CODA may be designed to provide shorter age and service periods (or no age or service requirements at all, allowing for immediate participation), as §401(k)(2)(D) merely establishes the maximum limits.

The SECURE Act of 2019 and the SECURE 2.0 Act of 2022 provide for shorter service limits for qualifying long-term, part-time employees ("LTPT" employees). In November 2023, the IRS issued a proposed regulation to reflect these statutory changes. The proposed regulation would apply for plan years that begin on or after January 1, 2024, and taxpayers may rely on the proposal until the final regulation is issued.[272] For this purpose, a "long-term, part time employee" is an employee eligible to participate in the CODA of a qualified §401(k) plan solely on account of: (1) completing two consecutive 12-month periods during which the employee is credited with at least 500 hours of service (or for plan years starting before January 1, 2025, three consecutive 12-month periods); and (2) attaining age 21 by the close of the consecutive 12-month periods.[273]

For plan years beginning on or after January 1, 2021, but before January 1, 2025, a qualified CODA may not require, as a condition of participation, that an employee complete (i) more than one year of service with the employer (or attain more than age 21 after having completed a year of service); or (ii) if earlier, three consecutive 12-month periods of having completed 500 hours of service with the employer, subject to the provisions of §401(k)(15).[274] However, 12-month periods beginning before January 1, 2021, are not taken into account in determining eligibility service for purposes of satisfying the requirement to have three consecutive 12-month periods of 500 hours of service.[275]

Practice Insight: The earliest date that part-time employees can become eligible to participate in a §401(k) plan under the SECURE Act[276] is January 1, 2024. Therefore, employers must measure and document the hours of service of part-time employees for each 12-month period beginning on January 1, 2021, in order to comply with the eligibility standards for participation in a qualified CODA.

For plan years beginning on or after January 1, 2025, the number of consecutive 12-month periods in which an employee must have completed 500 hours of service with the employer is reduced to two consecutive periods.[277] However, 12-month periods beginning before January 1, 2023, are not taken into account for determining eligibility.

Practice Insight: The earliest date that part-time employees can become eligible to participate in a §401(k) plan under the SECURE 2.0 Act's reduced standard of two consecutive 12-month periods of 500 hours of service is January 1, 2025.

> *Example:* For a calendar-year plan that adopts the most restrictive service requirements for participation allowed under §401(k)(2)(D), part-time employees who first complete 500 hours of service on the dates below, and continue to complete 500 hours of service for each subsequent plan year, will first become eligible on the corresponding date below:

First 12-Month Period of 500 Hours	First Year of Eligibility
January 1 – December 31, 2021	January 1, 2024
January 1 – December 31, 2022	January 1, 2025
January 1 – December 31, 2023	January 1, 2025
January 1 – December 31, 2024	January 1, 2026
January 1 – December 31, 2025	January 1, 2027
January 1 – December 31, 2026	January 1, 2028

A year of service generally means a 12-month period during which the employee has not less than 1,000 hours of ser-

[271] Reg. §1.401(k)-1(e)(3)(ii).

[272] REG-104194-23, 88 Fed. Reg. 82,796 (Nov. 27, 2023), adding Prop. Reg. §1.401(k)-5.

[273] §401(k)(2)(D), §401(k)(15); Prop. Reg. §1.401(k)-5(b)(1), REG-104194-23, 88 Fed. Reg. 82,796.

[274] Former §401(k)(2)(D), as amended by the SECURE Act of 2019, Pub. L. No. 116-94, Div. O, §112(a). The SECURE Act of 2019 is also referred to as "SECURE 1.0" by industry practitioners.

[275] *See* Pub. L. No. 116-94, Div. O, §112(b).

[276] Pub. L. No. 116-94, Div. O, §112.

[277] §401(k)(2)(D)(ii), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §125(c), effective for plan years beginning after December 31, 2024.

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vice.[278] Hours of service may be computed in different ways under the same service crediting rules that generally apply to all tax-qualified plans.[279] Section 401(k)(15)(A) imposes the additional requirement that the employee have attained age 21 by the close of the second or third (as applicable) 12-month period if participation is based on having completed the requisite consecutive 12-month periods of 500 hours of service.

In determining whether an employee has completed the requisite number of consecutive 12-month periods of service, §401(k)(15)(D)(ii) refers to the last sentence of §410(a)(3)(A), which provides that the computation of any 12-month period shall be made with reference to the date on which the employee's employment commenced, except that, under regulations prescribed by the Secretary of Labor, such computation may be made by reference to the first day of a plan year in the case of an employee who does not complete 1,000 hours of service during the 12-month period beginning on the date his employment commenced. In addition, 12-month periods beginning before January 1, 2021, shall not be taken into account.[280]

Practice Insight: Presumably, the last sentence of §410(a)(3)(A) does not apply, meaning that an employer cannot change the computation period to the plan year after the initial 12-month computation period that starts on the date the employee became employed, as §401(k)(15), by reference to §401(k)(2)(D)(ii), requires measurement using consecutive *12-month periods*. The use of alternative eligibility computation periods that is permissible under the last sentence of §410(a)(3)(A) could result in a total eligibility computation period that is less than 24 or 36 months, as applicable, which would seem to conflict with the statutory requirement of completing the requisite 12-month periods of 500 hours of service. Under proposed regulations issued in November 2023, if a plan provides that 12-month periods following the initial 12-month period are determined by reference to the first day of the plan year, an employee's initial and second 12-month periods are treated as consecutive 12-month periods in determining the employee's eligibility to participate as a long-term, part-time employee.[281]

Once a part-time employee is eligible to participate in the CODA on the basis of having completed either two or three (as applicable) consecutive 12-month periods of 500 hours of service and having attained age 21 by the close of such period, the same timing requirements apply for the employee's entry date as for full-time employees who complete a year of service.[282] Generally, this means that terms of the plan must provide that participation in the CODA must commence no later than the earlier of the first day of the first plan year beginning after the date on which such employee satisfied such requirements or the date that is six months after the date on which the employee satisfied such requirements.[283] In addition, once a part-time employee satisfies the eligibility requirements, the employee will remain eligible for the CODA even if the employee fails to maintain 500 hours of service in subsequent 12-month periods. This status continues until the employee becomes eligible as a full-time employee or moves into an excluded class of employment.[284]

Together, the age and service requirements provide an eligibility standard that allows for participation in §401(k) plans by employees who are typically considered to be "long-term, part-time employees." However, collectively bargained employees and employees who are nonresident aliens receiving no earned income are excluded from these eligibility standards.[285]

Periods during which an employee is excluded from the eligibility standards may be used to satisfy the LTPT employee participation requirements, so that the employee qualifies as a LTPT employee once the exclusion ceases to apply.[286]

Practice Insight: The service requirement limits apply only to the CODA itself. It is permissible for the plan containing the CODA to require two years of service as a condition for other benefits under the plan (assuming full and immediate vesting of such benefits). This is apparently true even for matching or other nonelective contributions used to help satisfy the §401(k)(3) nondiscrimination tests.

The proposed regulation would allow plans to establish eligibility conditions for participation in the CODA that are not based on age or service (e.g., requiring a specified job classification). However, additional conditions could not have the effect of imposing age or service requirements that extend beyond these requirements.[287] An employee that satisfies age and service requirements, but not the employer's non-age or service based eligibility condition would become eligible to participate in the CODA immediately upon satisfying the additional condition.[288]

Employers are not required to make nonelective or matching contributions on behalf of LTPT employees, even if nonelective or matching contributions are made to full-time employees.[289] Furthermore, employers would be permitted to make an election that excludes LTPT employees when determining whether the plan satisfies the following: nondiscrimination requirements under §401(a)(4); the ADP test under §401(k)(3) and ADP safe harbors under §401(k)(12) and §401(k)(13); the ACP test under §401(m)(2) and ACP safe harbors under §401(m)(11) and §401(m)(12); and minimum coverage requirements under §410(b).[290] The election option woulds not

[278] §410(a)(3)(A).

[279] §410(a)(3)(A); Reg. §1.410(a)-1 through §1.410(a)-9; 29 C.F.R. §2530.200b-2, §2530.200b-3.

[280] Pub. L. No. 116-94, Div. O, §112(b). *See* Prop. Reg. §1.401(k)-5(c)(2), §1.401(k)-5(d)(1), REG-104194-23.

[281] Prop. Reg. §1.401(k)-5(c)(2)(ii).

[282] §401(k)(2)(D)(ii), §401(k)(15)(D)(i).

[283] §401(k)(15)(D)(i), §410(a)(4). *See* Prop. Reg. §1.401(k)-5(c)(1)(i), REG-104194-23.

[284] *See* §401(k)(15)(B)(iii), §401(k)(15)(B)(iv). *See also* Prop. Reg. §1.401(k)-5(d)(2) (defining "former long-term, part-time employees"), REG-104194-23. Under the proposed regulation, employees would also become former LTPT employees if the employee fails to satisfy eligibility conditions that are non-age or service based.

[285] §401(k)(15)(C). *See* Prop. Reg. §1.401(k)-5(b)(1)(ii), REG-104194-23.

[286] Prop. Reg. §1.401(k)-5(b)(2)(xii) *Ex.* 12.

[287] Prop. Reg. §1.401(k)-5(c)(3), REG-104194-23.

[288] Prop. Reg. §1.401(k)-5(c)(1)(iii), REG-104194-23, 88 Fed. Reg. at 82,811.

[289] §401(k)(15)(B)(i); Prop. Reg. §1.401(k)-5(e)(1), REG-104194-23.

[290] Prop. Reg. §1.401(k)-5(f)(1), REG-104194-23. The employer would have to exclude all LTPT employees from each one of these provisions that otherwise applies to the plan. Prop. Reg. §1.401(k)-5(f)(1)(ii). Different rules would apply when determining whether the plan is a top-heavy plan. *See* Prop. Reg. §1.401(k)-5(f)(2). For top-heavy rules, see II.A.2.c., above.

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extend to SIMPLE 401(k) nondiscrimination provisions under §401(k)(11) and §401(m)(10).[291]

F. CODA Must Satisfy Other Statutory Requirements: §401(k)(4)

Section 401(k)(4) provides three additional requirements that must be satisfied for a CODA to be treated as a qualified CODA. First, no benefits other than matching contributions can be contingent on the employee having made an election to defer.[292] Second, certain types of governmental and tax-exempt organizations are not eligible to include CODAs in their tax-qualified plans.[293] Third, elective deferrals made under a qualified CODA generally cannot be taken into account in determining whether any other plan satisfies the tax-qualification requirements of §401(a) or the minimum participation standards of §410(b), subject to certain exceptions.[294] Although these additional requirements seem relatively straightforward, they can raise complex issues when applied to §401(k) plans.

1. No Benefits May Be Contingent Upon Election to Defer: §401(k)(4)(A)

Section 401(k)(4)(A) provides that a CODA will not be treated as qualified if any other benefit (other than a de minimis financial incentive not paid for with plan assets or matching contributions) provided by the employer "is conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash." This provision, often referred to as the contingent benefit rule, is subject to a number of exceptions that have been established by the regulations and have been applied in IRS rulings.

The statutory exception to the contingent benefit rule for de minimis financial incentives was added by the SECURE 2.0 Act to allow employers to make small gifts to incentivize employees to participate in the §401(k) plan.[295] The financial incentive may not be more than $250 in value.[296] An employer may not offer the incentive to employees for whom an election to defer is already in effect. However, an employer may provide a de minimis financial incentive in the form of installment payments that are contingent on the employee's continued participation in a §401(k) plan.[297]

> *Example 1:* Employer A announces on February 1, 2024, that any employee for whom an election to defer under a CODA is not in effect on that date and who, within the next 90 days, makes an election to defer, will receive a $200 gift card. Employee B, who previously was not participating in the §401(k) plan, elects to make a deferral on March 1, 2024. Employer A then provides Employee B with a $200 gift card as a de minimis financial incentive without causing the CODA to fail to be a qualified CODA.

> *Example 2:* Employer A offers a $100 gift card if employees elect to defer to the §401(k) plan and promises to provide an additional $100 gift card a year later if the employee continues to defer for a full year. Employee B elects to participate in the §401(k) plan and Employer A provides Employee B with a $100 gift card. Employee B continues to participate in the §401(k) plan for the full year. Employer A then provides Employee B with a second $100 gift card. The total $200 amount in gift cards is still an acceptable de minimis financial incentive.

De minimis financial incentives are considered compensation that is includible in the employee's gross income and subject to applicable withholding and reporting requirements. However, the de minimis financial incentives are not considered compensation, and thus not taxable, if an exception under the I.R.C. is satisfied.[298]

> *Example 3:* Employee B's $200 gift card from Example 1 is includible in Employee B's gross income and is a taxable fringe benefit for employment tax and reporting purposes because as a cash equivalent, it is not eligible for the de minimis fringe benefit exclusion under §132(e) and Reg. §1.132-6(c).

In addition to de minimis financial incentives, perhaps the most important exception to §401(k)(4)(A) is for matching contributions. Matching contributions are, by definition, contingent on the employee's election to contribute to the CODA (matching contributions are described in I.D.2., above).[299] Without this exception, employers could not otherwise make pre-tax contributions that are based on whether or not the employee makes an election to defer compensation or that can vary in amount in a way that is directly related to the amount of the employee's deferral election. In addition, §401(k)(4)(A) requires that in order for this exception to the contingent benefit rule to apply, the matching contributions must satisfy the definition of §401(m), which requires that the matching contributions satisfy the ACP test of §401(m)(2). Furthermore, employers are allowed to make matching contributions that are contingent on the employee's repayment of student loans.[300] This exception from the contingent benefit rule operates within the rules on matching contributions by treating the employee's student loan repayments as elective deferrals for purposes of making matching contributions.[301]

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[291] Prop. Reg. §1.401(k)-5(e)(2)(iii).

[292] §401(k)(4)(A).

[293] §401(k)(4)(B).

[294] §401(k)(4)(C).

[295] §401(k)(4)(A), as amended by the SECURE 2.0 Act, Pub. L. No. 117-328, Div. T, §113(a), effective for plan years beginning after December 29, 2022. The provision of a de minimis financial incentive is exempt from treatment as a prohibited transaction. §4975(d)(24) and ERISA §408(b)(21), added by Pub. L. No. 117-328, Div. T, §113(c)-(d).

[296] Notice 2024-2, Q&A D-1.

[297] Notice 2024-2, Q&A D-2.

[298] Notice 2024-2, Q&A D-5. See Reg. §1.132-6 for the de minimis fringe benefit rules.

[299] A matching contribution cannot be a de minimis financial incentive. Notice 2024-2, Q&A D-3.

[300] §401(m)(13), added by Pub. L. No. 117-328, Div. T, §110(c), effective for plan years beginning after December 31, 2023. *See* Notice 2024-63 (Q&A guidance regarding employer matching contributions for employees' qualified student loan payments).

[301] For a discussion of matching contributions based on student loan repayments, see II.F.1.c., below.

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In addition, the contingent benefit rule does not apply to any benefits chosen under a cafeteria plan in lieu of CODA contributions.[302]

The phrase "other benefit" is construed broadly under the regulations, which state that the term includes, but is not limited to, benefits under a defined benefit plan; nonelective employer 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 §83; dependent care assistance plans; the ability to make after-tax contributions; and salary increases and bonuses (other than those actually subject to the cash or deferred election).[303] However, the regulations provide that certain items that are "other benefits" under this definition of the phrase will not be treated as being conditioned on the employee's deferral election in the following circumstances:

- Plan loans and distributions of elective deferrals where the amount of the loan or distribution is based on the amount of the employee's account balance;[304]
- Benefits under an excess benefit plan in ERISA §3(36) that are dependent on the employee's electing to make or not make elective contributions;[305]
- Deferred compensation under a nonqualified deferred compensation plan that is dependent on the employee having made the maximum elective deferral contributions under the annual deferral limits of §402(g) or permitted under the terms of the plan;[306]
- After-tax employee contributions where the amount of elective contributions to the CODA reduces dollar-for-dollar the amount of after-tax employee contributions that can be made; and[307]
- Benefits under any other tax-qualified or nonqualified plan or arrangement where the elective contributions are or are not taken into account as compensation under the other plan or arrangement for the purposes of determining benefits.[308]

Practice Insight: Interestingly, the regulations do not address a situation where nonelective employer contributions, under the same plan or a separate defined contribution plan, may be cut back in order to satisfy the §415(c) limitations, depending on the level of elective contributions under a qualified CODA. Presumably, this does not make the nonelective employer contribution an impermissible contingent benefit.

The regulations specifically exclude certain other items from the contingent benefit rule entirely:

- matching contributions on elective deferrals;
- benefits, rights, or features (such as a plan loan) that require or result in withholding from the employee's pay and, thereby, reduce the amount that is available for elective deferrals;
- a reduction in the employer's top-heavy contributions under §416(c)(2) due to matching contributions on elective deferrals; and
- any benefit elected by the employee under a §125 cafeteria plan in lieu of an elective contribution under a qualified CODA.[309]

In addition, the IRS has issued several rulings that address the contingent benefit rule of §401(k)(4)(A) as applied to arrangements involving nonqualified deferred compensation plans, the purchase of insurance benefits to continue plan contributions in the event of disability, and contributions to incentivize the repayment of student loans. Although private letter rulings can only be relied upon by the taxpayer to which the ruling was issued, they do provide some insight into the IRS's view of these arrangements.

a. Nonqualified Deferred Compensation Plans

The most common situation in which the contingent benefit rule becomes relevant is the availability of nonqualified deferred compensation benefits that are directly related to the amount of elective contributions to a CODA. For example, employers may wish to provide highly compensated employees with an opportunity to defer, and perhaps receive matching credits on, contributions that exceed the CODA limits.

The regulations provide that nonqualified deferred compensation is treated as contingent only to the extent that an employee may receive additional deferred compensation under the nonqualified plan based upon the extent to which the employee makes or does not make elective contributions.[310] For example, participation in the nonqualified deferred compensation plan cannot be limited to individuals who elect not to make any contribution under the CODA.[311] Similarly, allowing employees to allocate their deferrals between the nonqualified deferred compensation plan and the CODA, subject to an aggregate maximum percentage of compensation, causes the maximum deferrals under the nonqualified plan to be contingent on the amount of elective deferrals under the CODA.[312]

As discussed above, however, deferred compensation under a nonqualified deferred compensation plan is not deemed to be contingent if it is dependent on the employee having made the maximum elective deferral contributions under the annual deferral limits of §402(g) or as permitted under the terms of the plan.[313] Thus, it is on this basis that the IRS has issued fa-

[302] Reg. §1.401(k)-1(e)(6)(i).

[303] Reg. §1.401(k)-1(e)(6)(ii). *See* PLR 201833012 (student loan repayment benefit does not violate contingent benefit rule where, under program, employer's nonelective contributions to retirement plan are not conditioned on employee making elective contributions to plan); PLR 9852026 (health insurance benefit purchased under §401(k) plan is not "other benefit" conditioned on election of deferrals under §401(k)(4)(A) and Reg. §1.401(k)-1(e)(6), if available to all eligible employees in same amount at same cost and regardless of whether or extent to which employee elects deferrals); PLR 200031060 and PLR 200235043 (purchase of long-term disability insurance policy did not violate contingent benefit rule).

[304] Reg. §1.401(k)-1(e)(6)(v).

[305] Reg. §1.401(k)-1(e)(6)(iii).

[306] Reg. §1.401(k)-1(e)(6)(iii).

[307] Reg. §1.401(k)-1(e)(6)(ii).

[308] Reg. §1.401(k)-1(e)(6)(ii).

[309] Reg. §1.401(k)-1(e)(6)(i).

[310] Reg. §1.401(k)-1(e)(6)(iv).

[311] Reg. §1.401(k)-1(e)(6)(vi) *Ex.* 1.

[312] Reg. §1.401(k)-1(e)(6)(vi) *Ex.* 2.

[313] Reg. §1.401(k)-1(e)(6)(iv).

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vorable rulings regarding nonqualified deferred compensation plans that do not violate the contingent benefit rule.[314]

Practice Insight: The scope of the term "maximum elective contributions permitted under the terms of the plan" is not entirely clear. Presumably, it refers not only to a set maximum (e.g., 10% or 15% of compensation) as set forth in the plan, but also the maximum permitted by the nondiscrimination test of §401(k)(3)(A)(ii), or a maximum established by the plan administrator in a given year to assure compliance with that nondiscrimination test.

b. *Insurance Benefits to Provide for Continued Plan Contributions*

In several rulings, the IRS has concluded that the purchase of insurance benefits to continue plan contributions in the event of disability did not constitute "other benefits" for purposes of the contingent benefit rule.[315] In these situations, the plans generally provided benefits designed to replace elective deferrals, matching contributions, and nonelective contributions that would have been credited to a participant's account under a qualified CODA had the participant not become disabled. The plans purchased insurance with plan assets, and employees were eligible for the benefit if they were not eligible to participate in the 401(k) plan or were eligible but had elected not to make elective deferrals. The IRS reasoned that although Reg. §1.401(k)-1(e)(6)(ii) includes health insurance and life insurance benefits under the definition of "other benefits," Reg. §1.401(k)-1(d)(6)(ii) makes it clear that a CODA may purchase life insurance with a participant's contributions without violating the contingent benefit rule.

c. *Contributions Based on Repayment of Student Loans*

Section 401(m)(13) permits employers to make matching contributions to a defined contribution plan, such as a §401(k) plan, that are contingent upon an employee having made "qualified student loan payments."[316] For plan years prior to 2024, the primary guidance on contributions based on the repayment of student loans is set forth in PLR 201833012, discussed below.

Section 401(m)(13) treats certain contributions made on account of student loan repayments as matching contributions, which provides a statutory exception to the contingent benefit rule of §401(k)(4)(A). In order for this exception to apply, the defined contribution plan must provide for all of the following terms:[317]

- matching contributions on account of elective deferrals at the same rate as contributions on account of qualified student loan payments;
- matching contributions on account of qualified student loan payments only on behalf of employees otherwise eligible to receive matching contributions on account of elective deferrals;
- all employees eligible to receive matching contributions on account of elective deferrals are eligible to receive matching contributions on account of qualified student loan payments; and
- matching contributions on account of qualified student loan payments vest in the same manner as matching contributions on account of elective deferrals.

For this purpose, a "qualified student loan payment" is defined as a payment made by an employee in repayment of a "qualified educational loan"[318] that the employee incurred to pay "qualified higher education expenses,"[319] up to the amount of the §402(g) limit, but applying the §402(g) limit as reduced by the amount of elective deferrals the employee made for the year.[320]

A plan cannot limit qualified student loan payment matches to qualified education loan payments for the employee's education, for specific degree programs, or for certain schools.[321] A qualified education loan is treated as incurred by an employee who makes a payment on the loan if the employee is legally obligated under the loan terms to pay. Thus, the match must be available to an employee who is a cosigner of a loan for their spouse or dependent if the employee makes the loan payments.[322]

The employee must certify annually to the employer making the matching contribution that the qualified student loan payment has been made on such qualified educational loan.[323] The certification to the plan must include the following information: (1) the loan payment amount; (2) the loan payment date; (3) that the employee made the payment; (4) that the loan being repaid is a qualified education loan and was used to pay for qualified higher education expenses of the employee, the employee's spouse, or the employee's dependent; and (5) that

[314] *See, e.g.*, PLR 9807027, PLR 9752018, PLR 9752017.

[315] PLR 200235043, PLR 200031060, PLR 9852026.

[316] §401(m)(13), added by SECURE 2.0 Act, of 2022, Pub. L. No. 117-328, Div. T, §110(c), effective for plan years beginning after December 31, 2023. Notice 2024-63 provides guidance regarding matching contributions made for qualified student plan payments and applies for plan years beginning after December 31, 2024. For plan years beginning in 2024, a plan sponsor may rely on a good faith, reasonable interpretation of SECURE 2.0 Act §110, which includes the guidance in Notice 2024-63. Notice 2024-63. For discussion of optional separate ADP testing, see Notice 2024-63, Q&A D-1.

[317] §401(m)(13)(A), added by Pub. L. No. 117-328, Div. T, §110(c), effective for plan years beginning after December 31, 2023. The qualified student loan payment match must be based on a loan payment made during the plan year in issue. *See* Notice 2024-63, Q&A A-6. A qualified student loan payment match feature may be added as a mid-year change to a 401(k) safe harbor plan, as long as the notice and election opportunity conditions set out in Notice 2016-16, §III.C (see IV.B.4., below) are met. Notice 2024-63, Q&A E-2.

[318] As defined by §221(d)(1) as a loan incurred solely to pay qualified higher education expenses incurred on behalf of the taxpayer or the taxpayer's spouse or dependent as of the time the indebtedness was incurred, paid or incurred within a reasonable period of time before or after the indebtedness is incurred, and are attributable to education furnished during a period during which the recipient was an "eligible student." It also includes the refinancing of a loan that satisfies the requirements above and a loan from a related party or retirement plan. *See* Notice 2024-63, Q&A A-1.

[319] As defined by §221(d)(2), "qualified higher education expenses" means the cost of attendance at an eligible educational institution, reduced by amounts excluded from gross income and certain payments.

[320] §401(m)(4)(D), added by Pub. L. No. 117-328, Div. T, §110(b), effective for plan years beginning after December 31, 2023. *See* Notice 2024-63, Q&A A-3.

[321] Notice 2024-63, Q&A A-4.

[322] A guarantor would not have a legal obligation to make payments unless the primary borrower defaults. Notice 2024-63, Q&A A-1.

[323] §401(m)(4)(D)(ii). *See* Notice 2024-63, Q&A B-3.

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the loan was incurred by the employee.[324] The employee may provide affirmative certification to confirm each of these items. In the alternative, for the loan payment amount and date, and the employee's status as payor, the employer may independently verify (for example, by allowing the payments to be made through payroll deduction) or the employee may passively certify (i.e., the lender provides written information about the loan payment amount and date to the plan, and the plan provides a statement to the employee that the employer assumes that the employee is the payor). The employee must affirmatively certify that the loan is a qualified education loan and that it is incurred by the employee. One way to do this would be to have the employee register the loan with the plan before the first loan payment for a match is claimed.[325]If an employee's certification is determined to be incorrect, the plan has the option to correct a match based on that certification, except that a match based on an operational failure in administering a qualified student loan payment match feature must be corrected. If a qualified student loan payment match is corrected due to an incorrect certification (for example, the loan is later forgiven), all such matches made under similar circumstances must be corrected.[326]

In implementing a qualified student loan payment match feature, a plan may establish any administrative procedures that are reasonable based on all relevant facts and circumstances. Factors considered in determining the reasonableness of the procedures is whether the matches are effectively available to all eligible employees and whether the procedures promote compliance with those match requirements.[327] A plan may have one or multiple match claim deadlines for a plan year, as long as the deadline is reasonable. For example, the plan may set an annual deadline that is three months after the end of a plan year.[328]

Practice Insight: Section 401(m)(13) essentially requires that the contribution rate, vesting terms, and eligibility requirements for receiving matching contributions are the same, regardless of whether they are made on elective deferrals or qualified student loan payments. Presumably, an employee may still make elective deferrals to the plan, but cannot receive matching contributions with respect to qualified student loan payments and elective deferrals in excess of the §402(g) amount. Plan sponsors who are considering adopting a similar plan feature will need to address how it affects other tax-qualification requirements for the plan, such as nondiscrimination and the use of safe harbor contributions. In addition, employers must consider, in light of the guidance above, what documentation will be required to demonstrate that the employee made student loan payments and how to track whether elective contributions and/or student loan repayments were made for each payroll period. The SECURE 2.0 Act requires the Treasury Department to issue regulations, including guidance that specifically permits employers to make matching contributions for qualified student loan payments at a frequency that is different from other matching contributions and to allow employers to establish reasonable procedures for employees to claim they are entitled to receive matching contributions under the plan.[329]

> *Example:* An employer provides for matching contributions for elective deferrals and for qualified student loan payments, matching 100% of employee contributions up to 5% of compensation. An employee makes qualified student loan payments in an amount equal to 5% of the employee's compensation and certifies to the employer that the payments were made. The employer will make a matching contribution to the employee's account under the plan equal to 100% of the employee's qualified student loan payments, up to 5% of the employee's compensation.

In PLR 201833012, the IRS ruled that amending a defined contribution plan with a qualified CODA to allow the employer to make an employer nonelective contribution on behalf of an employee conditioned on that employee making student loan repayments (known as a "SLR nonelective contribution") would not violate the contingent benefit rule of §401(k)(4)(A) and Reg. §1.401(k)-1(e)(6). The existing terms of the plan provided that eligible employees could make elective deferrals for each payroll period as pre-tax or Roth 401(k) contributions, or as after-tax employee contributions and that the employer would make a matching contribution equal to 5% of the employee's eligible compensation during the pay period if the employee made an election contribution equal to at least 2% of eligible compensation during the pay period.

The proposed amendment provided for a voluntary program in which the employer would make an SLR nonelective contribution as soon as practicable after the end of the year equal to 5% of the employee's eligible compensation for a pay period if an employee made a student loan repayment during a pay period equal to at least 2% of the employee's eligible compensation for the pay period. The SLR nonelective contribution would be made without regard to whether the employee made any elective contributions throughout the year. The employee would still be eligible to make elective contributions to the plan, but the employee would not be eligible to receive regular matching contributions with respect to those elective contributions while the employee participates in the program. If the employee did not make a student loan repayment for a pay period equal to at least 2% of the employee's eligible compensation, but did make an elective contribution during that pay period equal to at least 2% of the employee's eligible compensation for that pay period, then the employer would make a matching contribution as soon as practicable after the end of the plan year equal to 5% of the employee's eligible compensation for that

[324] Notice 2024-63, Q&A B-2.

[325] Notice 2024-63, Q&A B-2. If passive certification is used, the employee must have a reasonable period to correct the information in the employee notice. The employee is treated as having certified the information if the employee does not act within that period. Notice 2024-63, Q&A B-2. Independent verification or passive certification procedures must be reasonably available for all employees, so other reasonable means of verification must be permitted for an employee who does not have the ability to use the plan's specified procedure. *See* Notice 2024-63, Q&A C-3.

[326] Notice 2024-63, Q&A E-4.

[327] Notice 2024-63, Q&A C-1.

[328] Notice 2024-63, Q&A C-2. If a plan that adopts a qualified student loan payment match feature is concerned about the imposition of §4979 excess contribution excise taxes (see III.M.9., below) due to matches claimed after the 2½-month correction deadline under §4979(f), the plan may avoid this issue by either adopting reasonable loan payment match claim deadlines that are earlier than 2½ months after the end of a plan year or by adopting eligible automatic contribution arrangement (EACA) provisions (see II.B.2., above). Notice 2024-63 n.4.

[329] Notice 2024-63, Q&A E-3.

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pay period (true-up matching contribution). In order to receive either the SLR nonelective contribution or the true-up matching contribution, the employee would need to be employed by the taxpayer on the last day of the plan year (except in the case of termination of employment due to death or disability). Both SLR nonelective contributions and true-up matching contributions would be subject to the same vesting schedule as regular matching contributions.

The IRS reasoned that the SLR nonelective contributions under the program were conditioned on whether an employee made a student loan repayment during a pay period and were not conditioned (directly or indirectly) on the employee making elective contributions under the CODA. Furthermore, because an employee who made student loan repayments and thereby received the SLR nonelective contributions was still permitted to make elective contributions, the SLR nonelective contribution was not deemed to be conditioned (directly or indirectly) on the employee electing to have the employer make or not make contributions under the arrangement in lieu of receiving cash.

In other words, an employee who participated in the program could receive a 5% contribution from the employer in one of two ways: by making a student loan repayment during a pay period equal to at least 2% of the employee's eligible compensation for the pay period or by making an elective contribution during that pay period equal to at least 2% of the employee's eligible compensation. Thus, the cost to the employee of receiving the employer contribution is less. The employee need only make a student loan payment to receive the employer contribution, whereas in the absence of the voluntary program, the employee must make elective contributions to receive the employer contribution, in addition to making student loan payments (assuming the employee is obligated under the terms of the student loans to make regular payments). As such, this arrangement allowed the employer to incentivize employees to repay student loans and provide a means of making employer contributions on a pre-tax basis to employees who otherwise may not have the financial ability to defer part of their compensation to the CODA.

2. *Employer Must Be Eligible to Offer a CODA: §401(k)(4)(B)*

Section 401(k)(4)(B) provides that only certain types of employers may include a qualified CODA arrangement as part of the plan they maintain. Specifically, §401(k)(4)(B)(i) and §401(k)(4)(B)(iii) provide that certain tax-exempt organizations and Indian tribal governments may include qualified CODAs as part of a plan maintained by such organization or government. However, §401(k)(4)(B)(ii) prohibits qualified CODAs from being included as part of a plan that is sponsored by a state or local government or political subdivision thereof.

For a discussion of special rules and issues applicable to government-sponsored plans intended to meet the qualification requirements of §401(a), see 372 T.M., *Church and Governmental Plans.*

For a discussion of the special issues that arise in connection with the design and administration of employee benefit plans sponsored by private organizations that are exempt from federal income tax under §501, see 373 T.M., *Employee Benefits for Tax-Exempt Organizations.*

a. *State and Local Governments and Instrumentalities and Political Subdivisions*

An employer is not eligible to maintain a qualified CODA if it is considered a state or local government instrumentality or agency, unless the plan is a grandfathered plan that had a CODA in effect before May 7, 1986.[330] This prohibition applies even if the employer is also tax-exempt, such as under §501(c)(3),[331] which includes state or local government institutions such as state-operated hospitals, libraries, and museums that are recognized as tax-exempt organizations under various paragraphs of §501(c) because they are otherwise exempt from federal income tax as governmental entities.[332]

The question of whether or not a plan is a governmental plan within the meaning of the term as defined in §414(d) and, therefore, for purposes of §401(k)(4)(B), is a matter upon which the IRS will not issue a private letter ruling.[333] Otherwise, the IRS has generally looked to the standards in Rev. Rul. 89-49, which defines when a plan is a governmental plan under §414(d), to determine whether a plan is a state government plan for purposes of §401(k)(4)(B).[334] For example, the IRS has ruled privately that a state bar association escaped classification as a state instrumentality and could add a §401(k) arrangement to its qualified profit-sharing plan, reasoning that the rationale used in Rev. Rul. 89-49 for determining whether an organization is an agency or instrumentality of the United States or any state or political subdivision would be equally applicable whether the determination is being made for purposes of §414(d) or for purposes of §401(k)(4)(B).[335]

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[330] The 1986 TRA amended §401(k)(4) to prohibit state or local governments (including their subdivisions, agencies, and instrumentalities) and tax-exempt organizations from maintaining qualified CODAs, except for CODAs in effect before May 7, 1986 (or, in the case of tax-exempt organizations, before July 2, 1986), referred to as the "grandfather date." Pub. L. No. 99-514, §1116(f)(2)(B). This prohibition was lifted for nongovernmental tax-exempt employers, for plan years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996. Pub. L. No. 104-188, §1426, amending §401(k)(4)(B). Before the 1986 TRA, it was not entirely clear whether state or local governments (or their subdivisions, agencies, or instrumentalities) or tax-exempt employers could maintain qualified CODAs, other than as part of a "pre-ERISA money purchase plan." *See* §401(k)(6). These entities could not maintain stock bonus plans, because they issued no stock. It was widely believed, however, that they could maintain "profit-sharing plans," under which profits were simply defined as the excess of revenues over expenses. This view is supported by GCM 38283 (Feb. 15, 1980) and a General Information Letter from J. E. Griffith, Chief, Rulings Section, Exempt Organizations Technical Branch to C. Frederick Oliphant III, dated September 14, 1983. The GCM and general information letter also indicated that the IRS was disposed to rule favorably on the issue of whether maintenance of a qualified profit-sharing plan resulted in any prohibited inurement for the benefit of private individuals under various paragraphs of §501(c). See PLR 8508074 and PLR 8442064 for examples of favorable rulings.

[331] REG-155608-02, 69 Fed. Reg. 67,075, 67,078 (Nov. 16, 2004) (preamble to proposed §403(b) regulations) ("Based on the wording of section 401(k)(4)(B)(i) and (ii), an entity that is both a section 501(c)(3) organization and an instrumentality of a State cannot have a section 401(k) plan.").

[332] Rev. Rul. 67-290, Rev. Rul. 74-15.

[333] Rev. Proc. 2025-4, §9.04 (IRS will not review whether plan is governmental plan under §414(d)).

[334] *See, e.g.,* PLR 200313017, PLR 200250039. *See also* REG-157714-06, 76 Fed. Reg. 69,172 (Nov. 8, 2011), amended at 76 Fed. Reg. 76,633 (Dec. 8, 2011).

[335] PLR 9749014. In PLR 200244021, the IRS followed the same reasoning in ruling that a corporation that was a joint venture between the public and private sectors was not a government agency or instrumentality and, thus, was el-

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(1) Exception for Rural Cooperatives Organized as Part of State or Local Governments

The prohibition of CODAs in plans maintained by state and local governments, however, does not extend to mutual irrigation or ditch companies or districts organized under the laws of a state as a municipal corporation for the purpose of irrigation, water conservation, or drainage, and such entities may maintain §401(k) qualified cash or deferred arrangements.[336] For these purposes, a mutual irrigation or ditch company is described in §501(c)(12) without regard to the 85% requirement of that provision. In addition, a national association of such mutual irrigation or ditch companies or districts is permitted to maintain a §401(k) qualified CODA.[337] The rule applies to all mutual irrigation or ditch companies and districts regardless of whether the company or district is a tax-exempt or taxable entity or part of a state or local government. These types of entities are specifically authorized, by statute, to maintain a CODA, as they are included in the definition of a "rural cooperative" under §401(k)(7)(B). As discussed in II., above, rural cooperatives are the only types of entities that can sponsor a rural cooperative plan, which is one of the four types of plan that §401(k)(1) allows to include a CODA.

(2) Grandfathered Governmental Plans

According to the 1986 TRA Bluebook, a plan is considered adopted before the applicable grandfather date even if the trust is not yet created under the plan. The Bluebook also states that a safe harbor is intended under which a plan would be considered adopted "as of the date of formal approval by the governing body of the organization under a definite written plan that is binding upon the organization."[338]

The 1986 TRA Conference Report states, and the §401(k) regulations provide, that the grandfather treatment is limited to the "employers who adopted the plan" before the grandfather date, but that "the grandfather treatment is not limited to employees (or classes of employees) covered by the plan" as of that date.[339] The Technical and Miscellaneous Revenue Act of 1988[340] amended 1986 TRA §1116(f)(2) to clarify that governmental employers which adopted a CODA in a timely manner under the 1986 TRA grandfathering rules may not only maintain grandfathered CODAs but may also establish new ones. However, an employer with a grandfathered profit-sharing plan, but no CODA, may not later amend the profit-sharing plan to add a qualified CODA for the first time. The §401(k) regulations provide that if an employer had adopted (or made a legally binding commitment to adopt) a CODA before the grandfather date, all employees of the employer may participate in the CODA.[341] Thus, new employees of the employer maintaining the CODA on the grandfather date may be added to the plan, and entire classes or categories of employees of the employer may apparently be made eligible even if they were ineligible on the grandfather date.[342]

In the case of state or local governmental plans, the identity of the "employer" may be unclear. For example, if one agency of a state government maintains a qualified CODA, the question arises of whether the plan can be expanded to cover other employees of the state government, or of any other subdivision, agency, or instrumentality thereof. The IRS has suggested in a handful of private letter rulings that whether a grandfathered plan sponsored by a particular state agency or instrumentality can be extended to another state agency or instrumentality, without failing to comply with §401(k)(4)(B), depends on a determination that such employers are required to be aggregated under §414(b) or §414(c).[343] In Notice 89-23,[344] the IRS generally indicated that two entities must be aggregated if one entity has the power to levy taxes to provide funds to the other entity or if one entity receives a majority of its tax disbursements pursuant to the same tax levy applicable to another entity. However, in the mid-1990s, the IRS acknowledged that questions had arisen about these standards and provided that governments may apply a reasonable, good faith interpretation of existing law in determining which entities must be aggregated.[345] The IRS has never successfully revisited the issue of governmental plan aggregation and, moreover, generally has been unwilling to issue rulings on whether two governmental entities are aggregated, although the IRS has not been entirely consistent in its unwillingness to rule on the issue.[346]

All qualified plans maintained by governments or political subdivisions, agencies, or instrumentalities thereof, are permanently exempt from the nondiscrimination and minimum participation rules.[347] In addition, these plans are treated as meet-

igible to sponsor a §401(k) plan. The corporation was exempt from tax under §501(c)(6) as a business league and was established in order to develop and operate an information network and database that covers each U.S. state, territory and insular possession. In applying the standards of Rev. Rul. 89-49 to the corporation in this ruling, the IRS concluded that the private sector had substantial control over the corporation.

[336] §401(k)(7)(B)(iv).

[337] §401(k)(7)(B)(v).

[338] Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (1986 TRA Bluebook) (May 4, 1987) at 643.

[339] 1986 TRA Conf. Rep. at II-391; Reg. §1.401(k)-1(e)(4)(i), §1.401(k)-1(e)(4)(iv).

[340] Pub. L. No. 100-647, §1011(k)(8) (TAMRA).

[341] Reg. §1.401(k)-1(e)(4)(i), §1.401(k)-1(e)(4)(iv).

[342] Reg. §1.401(k)-1(e)(4)(i), §1.401(k)-1(e)(4)(iv). In PLR 9842064, Entity A adopted Plan X, a plan containing a CODA, on June 1, 1985. The IRS ruled that pursuant to Reg. §1.401(k)-1(e)(4), any cash or deferred arrangement adopted by Entity A at any time would be treated as adopted before May 6, 1986, and was thus qualified under §401(k)(4)(B)(ii). Therefore, since Sub-entity B (a service board affiliated with Entity A) was part of Entity A, the IRS concluded that a cash or deferred arrangement adopted by Sub-entity B would be treated as adopted before May 6, 1986.

[343] *See, e.g.*, PLR 200307093, PLR 200250039, PLR 200125094.

[344] In July 2007, the IRS established aggregation rules for tax-exempt employers but did not revisit the question of governmental plan aggregation. T.D. 9340, 72 Fed. Reg. 41,128 (July 26, 2007), as corrected, 75 Fed. Reg. 65,566 (Oct. 26, 2010) (§403(b) final regulations). Notice 89-23 was declared obsolete by Rev. Rul. 2009-18, except to the extent described in the last paragraph of the "Treatment of Controlled Groups that Include Tax-Exempt Entities" section of the preamble to T.D. 9340, 72 Fed. Reg. at 41,138.

[345] Notice 96-64; Announcement 95-48, *obsoleted by* Rev. Rul. 2009-18.

[346] *Compare* PLR 200307093 (concluding that aggregating two particular entities is a reasonable interpretation of the aggregation rules) *with* PLR 200125094 (refusing to rule on whether aggregation was a reasonable interpretation of the applicable rules).

[347] Pub. L. No. 105-34, §1505(a), §1505(b), and §1505(d), enacting or amending §401(a)(5)(G), §401(a)(26)(H), §410(c)(2), and §401(k)(3)(G); *see also* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 738–39 (1997). For effective dates prior to the enactment of the Taxpayer Relief Act of 1997, see Announcement 95-48 and Notice 96-64. The Pension Protection Act of 2006, Pub. L. No. 109-280, §861(a), amended the relevant provisions to clarify that governmental entities other that state governments, such as international orga-

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ing the requirements of §401(a)(3), §401(a)(4), §401(a)(26), §401(k), §401(m), and §410.[348] In the case of state governmental entities, this change was effective for tax years beginning on or after August 5, 1997, and, in the case of all other governmental entities, the change was effective August 17, 2006.

(3) Interaction with §414(h)

Section 414(h)(1) generally provides that if a contribution is designated as an employee contribution, it will not be treated as an employer contribution and, therefore, will be treated as an after-tax contribution. Section 414(h)(2), however, provides a special rule that allows a governmental employer to "pick up" employee contributions. Under this rule, contributions, although designated as employee contributions, are nevertheless treated as pre-tax employer contributions if the contributions are "picked up" by the employing governmental unit. A contribution qualifies as a pick-up contribution only if: (i) the employer formally specifies that the contributions, although designated as employee contributions, are being paid by the employer in lieu of contributions by the employee; and (ii) the employee is not permitted to opt out of the pick-up and receive the contributed amount directly instead of having it paid to the plan.[349] For example, in PLR 201417025, a state adopted legislation requiring mandatory employee contributions (3% of compensation) to the retirement plan in which employees participated, that had to be designated as employee contributions, but were picked up by participating employers and treated as employer contributions. The legislation did not allow employees the option of choosing to receive the contributed amounts directly. Specifying that the contributions were being paid by the employer in lieu of contributions by employees, the legislation required that they be treated as employer contributions under §414(h)(2). The IRS ruled that the legislation satisfied its criteria for a contribution to be a pick-up contribution.

The second requirement has been the source of some confusion because IRS rulings also make clear that a pick-up contribution may be effected through a reduction in salary, an offset against future salary increases or a combination of both,[350] and the IRS has issued a number of private letter rulings in which it approved "pick-up" arrangements that appear to involve the employer picking up an amount that the employee elected to contribute to the plan.[351] The PLRs, however, do not address §401(k)(4)(B) and its interaction with §414(h)(2).[352]

For example, in PLR 200252095, firefighters who were covered by a governmental plan were given an opportunity to elect at any time prior to three months before retirement to have a portion of their unused sick leave, vacation, and compensatory time that would have been paid to them in cash at termination of employment instead contributed to the plan. The city then picked up the amount elected by the firefighters. The PLR indicates that the firefighters would not have the right to receive cash after the election but it is apparent from the ruling that the termination pay would have been cashed out but for the election to defer. Such an election is clearly a cash or deferred election within the meaning of §401(k) and the §401(k)(4)(B) prohibition against qualified governmental CODAs. Nonetheless, the PLR concludes that the contributions are not includible in income.

These rulings suggest that §414(h)(2) modifies the §401(k)(4)(B) prohibition against qualified governmental CODAs or at least provides an alternative vehicle for contributions that are comparable to elective deferrals. It is not clear, however, that the IRS still subscribes to the view reflected in the private letter rulings. Rev. Rul. 2006-43 reiterates the rule against providing employees a choice to receive cash in lieu of a contribution. For the first time, however, the IRS specifically stated that, to constitute a valid "pick-up" contribution, an employee cannot have a "cash or deferred election right (within the meaning of Reg. §1.401(k)-1(a)(3))," which would clearly preclude the types of elections approved in the PLRs. There have been no additional PLRs issued since the 2006 revenue ruling that would appear to allow for an employee election with respect to "pick-up" contributions.

b. Nongovernmental Tax-Exempt Employers

Nongovernmental tax-exempt employers may include qualified CODAs as part of a tax-qualified plan.[353] For §501(c)(3) organizations, the benefits of qualified CODAs are not so clear, given the existing availability of tax-deferred annuity plans under §403(b). Elective contributions under §403(b) are not subject to the special nondiscrimination tests in §401(k)(3)(A)(ii)[354] and are subject to higher applicable contribution limits for certain employees.[355] Moving from §403(b) to a qual-

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nizations and federal government agencies, are also exempt from the nondiscrimination and minimum participation rules.

[348] Pub. L. No. 105-34, §1505(d).

[349] Rev. Rul. 2006-43, *modifying and amplifying* Rev. Rul. 81-35, Rev. Rul. 81-36, and Rev. Rul. 87-10. *See* Rev. Proc. 2025-4, §9.06 (IRS will not review plan for whether contributions satisfy §414(h)).

[350] Rev. Rul. 81-35, Rev. Rul. 81-36. Changing the method of picking up mandatory contributions from an offset against future salary increases to a salary reduction does not change the federal tax or income tax withholding treatment of the contributions. PLR 201305021.

[351] *See, e.g.*, PLR 200333039 (approving pick-up arrangement involving election of wide range of deferral percentages at any time within 24 months of initial eligibility), PLR 200249009 (stating that one-time irrevocable election by employees to contribute accrued termination pay to Plan after commencement of participation constituted a "pick-up" under §414(h)(2)). *See also* PLR 202126001 (plan language permitting the hiring of retired plan-participant schoolteachers to return to the classroom as "special employees" did not create an employee election that could constitute cash or deferred arrangement under §401(k); the rehired retirees continued to receive retirement benefits from the plan, were ineligible to accrue further benefits, and were not able to make an election as to whether to receive cash or make a contribution to the plan).

[352] The PLRs generally involve a one-time irrevocable election to defer compensation. However, these elections are available after the first day on which the employees become eligible to participate in a qualified plan maintained by the employer and, therefore, do not fall within the exception from the definition of a CODA for one-time irrevocable elections. *See* Reg. §1.401(k)-1(a)(3)(v).

[353] Only for plan years beginning after December 31, 1996. Before that time, only "grandfathered" CODAs in effect before July 2, 1986, were permitted for these employers. Rules similar to those discussed in II.F.1.a., above applied in determining grandfathered status of CODAs maintained by nongovernmental tax-exempt employers, except for the rule that grandfathered governmental employers could establish new CODAs. Pre-2006 Reg. §1.401(k)-1(e)(4)(ii) and §1.401(k)-1(e)(4)(iii). Until 1997, these employers could offer no tax-deferred, nonforfeitable deferred compensation opportunity for rank-and-file employees. While such a plan could be maintained under §457(b) for a select group of management or highly compensated employees, deferrals under such a plan were then limited to a lower annual dollar amount, in addition to being subject to the claims of the employer's creditors. *See* ERISA §301(a)(3).

[354] See §403(b)(12)(A)(ii), which, instead, imposes a universal availability requirement.

[355] §402(g)(7).

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ified CODA may also require continued maintenance of two separate plans, since the §403(b) plan and accounts may not be merged into or transferred to a qualified plan (apart from an eligible rollover distribution). Other considerations also apply to a §501(c)(3) employer's choice between §401(k) and §403(b), depending on the facts and circumstances.

Some tax-exempt employers have taxable affiliates. Employees of taxable affiliates cannot be covered by a §403(b) plan and some tax-exempt employers maintain a qualified CODA so that all employees of the tax-exempt employer and its taxable affiliate may be covered by a single plan. In other instances, the tax-exempt employer will maintain a §403(b) plan and the taxable employer will maintain a qualified CODA. The minimum participation requirement of §401(a)(26) and the minimum coverage requirements of §410(b) that a qualified CODA must satisfy generally apply on a controlled group basis, raising the possibility that it will be difficult, or even impossible, for the normally applicable §401(a)(26) and §410(b) rules to be satisfied, for example, if the taxable affiliate has a very small number of employees or a disproportionate number of highly compensated employees, or both. The IRS has, however, issued relief that permits the taxable affiliate to exclude for testing purposes employees of governmental or tax-exempt affiliates that were precluded from CODA eligibility by reason of §401(k)(4)(B) and employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a §403(b) plan, so long as more than 95% of the employees who were not so precluded were made eligible for the qualified CODA.[356]

An interesting issue is raised by the possibility that a private entity which sponsors a qualified CODA may become a governmental entity that may not maintain a qualified CODA. There is no authority directly addressing this issue, but it was addressed in at least one private letter ruling dealing with the former prohibition against a tax-exempt employer maintaining a qualified CODA. PLR 200025064 involved the acquisition by a tax-exempt medical center of the assets of its taxable physician practice management subsidiary and a physician's medical care contractor and the contribution of these assets to a tax-exempt medical foundation. As of the date of this merger, participants in two §401(k) plans were no longer allowed to make elective deferrals, and all employer contributions to the plans ceased. The tax-exempt entity was responsible for crediting account balances with earnings and losses, making plan distributions and assuring that the plans comply with IRS regulations. The IRS ruled that the freezing and subsequent administration of (and distributions from) the two plans did not constitute maintenance of §401(k) arrangements by a tax-exempt entity under former §401(k)(4)(B)(ii) and did not adversely affect the qualified status of the arrangements under §401(k).

c. Indian Tribal Governments

Indian tribal governments, their agencies or instrumentalities, any subdivisions thereof, and any corporations chartered under federal, state, or tribal law that are owned, in whole or in part by any of the foregoing, may maintain qualified CODAs for plan years beginning after December 31, 1996.[357] Indian tribal governments are defined in §7701(a)(40).

Although Indian tribal governments, political subdivisions, agencies, or instrumentalities thereof are eligible to maintain qualified CODAs, certain plans maintained by these entities are subject to the nondiscrimination and minimum participation rules, including the rules that apply to qualified CODAs.[358] A plan maintained by an Indian tribal governmental entity is a governmental plan and, therefore, exempt from the nondiscrimination and minimum participation requirements, only if all of the participants in the plan are "qualified employees."[359] Qualified employees are employees whose services are in the performance of essential governmental services and not in the performance of commercial activities (whether or not such activities are an essential governmental function).[360] As a result, for example, a governmental plan would include a plan of a tribal government all of the participants of which are teachers in tribal schools, but would not include a plan covering tribal employees who are employed by a hotel, casino, service station, convenience store, or marina operated by a tribal government.[361]

3. Elective Deferrals Cannot Be Used to Help Another Plan Satisfy §401(a) or §410(b): §401(k)(4)(C)

Section 401(k)(4)(C) provides that any elective contribution under a qualified CODA generally may not be taken into account for purposes of determining whether any other plan satisfies §401(a) or §410(b). This means, for example, that elective CODA contributions may not be used to help satisfy the minimum contribution requirement for a top-heavy plan.[362] However, qualified nonelective contributions (QNECs) that are treated as elective contributions for purposes of the ADP test in §401(k)(3)(A)(ii) may count toward this minimum contribution requirement.[363] In addition, contributions made through a qualified CODA may be taken into account in applying the average

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[356] Reg. §1.401(a)(26)-1(b)(4), §1.410(b)-6(g).

[357] §401(k)(4)(B)(iii), added by Pub. L. No. 104-188, §1426(a); Reg. §1.401(k)-1(e)(4)(ii). The Conference Committee Report accompanying this law states that no inference is intended with respect to whether Indian tribal governments or related employers could have maintained qualified CODAs under the law in effect before 1997. H.R. Rep. No. 737, 104th Cong., 2d Sess. (1996) (1996 Conf. Rep.) at 247.

[358] §414(d), as amended by Pub. L. No. 109-280, §906(a).

[359] The Pension Protection Act of 2006 (2006 PPA) amended the definition of governmental plan in this regard. The 2006 PPA change to the definition of "governmental plan" for Indian tribal governments is effective for plan years beginning on or after the August 17, 2006, date of enactment, which left many tribal governments with very little time to restructure their plans to satisfy the applicable nondiscrimination and minimum participation requirements. Further, there are a number of questions about the line between commercial and non-commercial activities for which guidance is needed. Accordingly, the IRS has indicated that it will treat an Indian tribal governmental plan as a governmental plan if the plan satisfies the 2006 PPA definition based on a reasonable and good faith interpretation of the law. This reasonable good faith standard will be in effect until six months after final regulations are issued under §414(d) addressing the definition of an Indian tribal government. Notice 2007-67, Notice 2006-89. *See* REG-133223-08, 76 Fed. Reg. 69,188 (Nov. 8, 2011), amended at 76 Fed. Reg. 76,633 (Dec. 8, 2011).

[360] §414(d).

[361] Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 4, the 'Pension Protection Act of 2006'* (JCX-38-06) (Aug. 3, 2006) (2006 PPA Bluebook) at 244.

[362] Reg. §1.401(k)-1(e)(1).

[363] Reg. §1.401(k)-1(e)(1).

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benefit requirement of §410(b)(2)(A)(ii).[364] They may also be combined with matching contributions and after-tax employee contributions for purposes of satisfying §401(m), to the extent permitted by §401(m).[365]

G. *CODA Must Satisfy Automatic Enrollment and Escalation Requirements: §414A*

Effective for plan years beginning after December 31, 2024, a CODA established on or after the SECURE 2.0 Act's December 29, 2022, date of enactment will not be treated as a qualified CODA under §401(k) unless it meets the automatic enrollment and contribution escalation requirements of §414A.[366] However, a CODA established before December 29, 2022 (sometimes referred to for this purpose as a "pre-enactment qualified CODA"), is not subject to the §414A requirements.[367] A plan with a CODA feature that is initially adopted before December 29, 2022, but not effective until after December 29, 2022, is considered to be established before December 29, 2022, and thus is not required to satisfy this automatic enrollment and contribution escalation requirement.[368] If a single employer plan with a pre-enactment qualified CODA is merged with a single employer plan or a plan maintained by multiple employers that also has a pre-enactment qualified CODA feature, the CODA included in the ongoing plan remains exempt from the §414A requirements.[369]

Generally, all §401(k) plans and CODA features adopted and established on or after December 29, 2022, must provide for automatic enrollment and contribution escalation for plan years beginning on or after January 1, 2025, pursuant to the rules discussed below.[370] There are exceptions to this requirement for SIMPLE 401(k) plans,[371] governmental plans and church plans,[372] new businesses (for the first three years of existence),[373] and small businesses (until one year after the close of the first tax year in which the small business normally employs more than 10 employees).[374]

In order to be treated as a qualified CODA, §414A requires that the plan provide for:

- An "eligible automatic contribution arrangement" described in §414(w)(3), which is discussed in more detail in VI., below, and generally authorizes automatic elective contributions to be made in a uniform percentage and provides for certain notice requirements;[375]
- Employees to make "permissible withdrawals" as defined in §414(w)(2), which is discussed in more detail in VI.A., below, and generally allows automatically enrolled participants to unwind their enrollment by electing to withdraw contributions within a certain time frame;[376]
- A default contribution rate of at least 3% and not more than 10% of the participant's compensation during the first year of participation (unless the participant specifically elects a different contribution percentage, including zero);[377]
- An automatic 1% increase to the contribution rate as of the first day of each plan year starting after each completed year of participation, up to at least 10%, but not more than 15% percent (unless the participant specifically elects a different contribution percentage, including zero);[378] and
- The investment of employee contributions for which participants do not make investment elections in a qual-

[364] Reg. §1.401(k)-1(e)(1).

[365] Reg. §1.401(k)-1(e)(1), §1.401(m)-2(a)(6)(iii).

[366] §414A, added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §101(a), effective for plan years beginning after December 31, 2024. *See also* Prop. Reg. §1.414A-1, REG-100669-24, 90 Fed. Reg. 3092 (Jan. 14, 2025), proposed to apply to plan years beginning after the date that is six months after the publication of a final rule. For earlier plan years, a plan that complies with a reasonable, good faith interpretation of §414A is treated as having complied with §414A. Prop. Reg. §1.414A-1(f)(2). Pre-enactment status would not be affected by plan amendments, except amendments related to plan merger or adoption of a multiple employer plan. Prop. Reg. §1.414A-1(e)(6); 90 Fed. Reg. at 3100 (preamble to proposed rule).

[367] §414A(c)(2)(A). However, the exception does not apply if an employer adopts a plan maintained by multiple employers after December 29, 2022. §414A(c)(2)(B). This would apply on an employer-by-employer basis. It would not affect whether the multiple employer plan is treated as a pre-enactment plan for other employers maintaining the plan. Prop. Reg. §1.414A-1(e)(4)(iii).

[368] Notice 2024-2, Q&A A-1 (§414A(c)(2)(A)(i) exception); Prop. Reg. §1.414A-1(e)(1), §1.414A-1(e)(2).

[369] Notice 2024-2, Q&A A-2; Prop. Reg. §1.414A-1(e)(1). Similar treatment may apply in a spinoff. *See* Notice 2024-2, Q&A A-4; Prop. Reg. §1.414A-1(e)(5). If a plan in the merger does not have a pre-enactment qualified CODA, whether the ongoing plan must satisfy the automatic enrollment and escalation requirements depends on which plan is designated as the ongoing plan. *See* Notice 2024-2, Q&A A-3; Prop. Reg. §1.414A-1(e)(3), §1.414A-1(e)(4). However, the proposed rule would provide that, if an employer maintains a pre-enactment plan that is merged into a multiple employer plan after December 29, 2022, the post-merger multiple employer plan would be treated as a pre-enactment plan for that employer without regard to when the multiple employer plan is established. Prop. Reg. §1.414A-1(e)(3)(ii), §1.414A-1(e)(4)(ii).

[370] For example, starter §401(k) deferral-only arrangements, discussed in IV.F., must comply unless an exception applies. Notice 2024-2, Q&A A-6; Prop. Reg. §1.414A-1(b).

[371] §414A(c)(1).

[372] §414A(c)(3).

[373] §414A(c)(4)(A). To avoid mid-plan year implementation, the automatic enrollment requirements would not apply for a plan year if, at the start of the plan year, the employer (aggregated with any predecessor employer) has been in existence for less than three years. Prop. Reg. §1.414A-1(d)(4)(i).

[374] §414A(c)(4)(B). *See* Prop. Reg. §1.414A-1(d)(4)(ii) (proposing use of COBRA definition of "normally employed" in Reg. §54.4980B-2, Q&A-5). If a plan is maintained by multiple employers, the new business and small business exceptions are applied separately for each employer. All employers that must meet the automatic enrollment requirement, when considered separately, are treated as maintaining a separate plan for purposes of §414A. §414A(c)(4)(C).

[375] §414A(b)(1).

[376] §414A(b)(2). *See* Prop. Reg. §1.414A-1(c)(2).

[377] §414A(b)(3)(A)(i). Under the proposed rules, an employee's first year of participation or "initial period" would start when the employee is first eligible to elect to have contributions made, but not before the plan is first required to meet the §414A automatic enrollment requirements, and it would end on the last day of the following plan year. Prop. Reg. §1.414A-1(c)(3)(ii). A plan would be permitted to make certain redeterminations for periods without default contributions, including redetermination of an employee's initial period if, after the employee's initial period had begun, the employee did not have default elective contributions made for the full plan year. Prop. Reg. §1.414A-1(c)(3)(iv). The proposed rule also would allow exceptions to the uniform percentage requirement like those from the uniform percentage requirement of §414(w)(3)(B) (see VI.C.1., below). Prop. Reg. §1.414A-1(c)(3)(iii).

[378] §414A(b)(3)(A)(ii). For plan years ending before January 1, 2025, in the case of non-safe harbor plans (i.e., plans that do not satisfy the requirements of §401(k)(12) or §401(k)(13)), the automatic increase to the contribution rate cannot exceed 10%. §414A(b)(3)(B).

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ified default investment alternative under 29 C.F.R. §2550.404c-5.[379]

Proposed rules would permit an exclusion from the default election under the eligible automatic contribution arrangement for an employee who, on the date the plan first must satisfy the automatic enrollment requirements of the proposed regulation, had and continues to have an affirmative election to contribute a specified amount or percentage of compensation under a cash or deferred election or a salary reduction agreement or to not have contributions made on the employee's behalf.[380] For plan years before final rules would apply, plans may comply with a reasonable, good faith interpretation of §414A.

Practice Insight: Although qualified CODAs established on or after December 29, 2022, do not have to include the automatic enrollment and contribution escalation requirements until the plan year beginning on or after January 1, 2025, it may be advisable for any employer that is establishing a qualified CODA for the first time to comply with the automatic enrollment and contribution escalation requirements before then to avoid having to amend the plan and change its administrative procedures prior to the January 1, 2025, effective date.

H. Effect of a Qualified CODA on Other Benefits

1. Inclusion of a CODA in a Cafeteria Plan

If a CODA is included as an option under a cafeteria plan described in §125, the CODA may be subject to certain additional requirements imposed by §125 and the proposed regulations thereunder. For example, a salary reduction or other cash or deferral election might have to be made in advance of the plan year or other "period of coverage," and might be irrevocable before the end of that period of coverage except for certain changes in family status. For a discussion of the requirements of §125, including those that may apply to a CODA included in a cafeteria plan, see 397 T.M., *Cafeteria Plans*.

When a qualified CODA is included in a cafeteria plan, employers may inadvertently fail to comply with the requirement that every elective contribution under a qualified CODA be available to the employee in cash.[381] Cafeteria plans may be designed to offer some level of employer contribution that can be applied to purchase certain benefit coverages but not taken in cash. If that employer contribution can also be contributed, at the employee's election, to a qualified profit-sharing or stock bonus plan, that contribution is not an elective contribution that can be made to a qualified CODA, because it is not available in cash. Assuming it is not available in any taxable form to the employee, it would be treated as a nonelective employer contribution subject to the general rules of §401(a)(4) and §410(b), among other provisions. Because such contributions may vary from employee to employee, it may well be difficult to satisfy those provisions.

2. Effect of a Qualified CODA on Social Security Benefits

Elective contributions for the benefit of an employee under a qualified CODA are included in the employee's "wages" for FICA and FUTA tax purposes and, therefore, for purposes of computing Social Security and federal unemployment benefits.[382] Thus, while an election to reduce compensation and have elective contributions made under a qualified CODA will have the effect of deferring federal income tax on the amount of the contribution, Social Security and federal unemployment taxes will not be saved or deferred. In addition, the employee's Social Security and unemployment benefits will not suffer as a result of the salary reduction election.

> *Example:* An employee agrees to a reduction in his salary for a year from $20,000 to $18,000, with the remaining $2,000 being contributed by the employer to a profit-sharing plan under a qualified CODA. The employee and the employer will pay FICA taxes on the full $20,000 salary.

As most CODAs provide for the full amount of each elective contribution to be paid to the trust, the FICA tax owed by the employee on that contribution must be withheld from other compensation paid in cash to the employee. The tax need not be withheld until the elective contributions are contributed to the trust, because these contributions are not included in wages until that time under §3121(v). It is generally simpler, however, to withhold the tax from the paycheck which has been reduced by the amount of the contribution in question, and compute the FICA taxes on the gross pay for the pay period before any compensation reduction for the elective deferral.

Even if an employee's compensation after reduction for a deferral election equals or exceeds the Social Security wage base for the year, full Social Security taxes must be paid and withheld with respect to elective contributions under the qualified CODA until the employee's aggregate wages for the year (including the elective contributions) equal the wage base. This is consistent with the general approach of §3121(a)(1), which excludes from wages any amount in excess of the wage base only after wages equal to the wage base have already been paid during the calendar year. In any event, the additional Medicare tax now applies to wages without limitation.[383]

If a CODA permits deferral of annual bonus payments, and if the deferred bonuses are contributed to the trust early in the calendar year, the FICA taxes to be withheld from the deferred bonuses may be substantial. The employer could in theory choose to withhold the FICA tax from the deferred bonus itself instead of from current salary. In this case, only the net amount of the bonus contribution would be taken into account in applying the 1.25 and 2.0 tests of §401(k)(3)(A) and the limitation of §402(g).[384]

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[379] §414A(b)(4). If a plan with a CODA feature that includes a pension-linked savings account (PLESA) (see V.B.5., below) is subject to this automatic enrollment requirement, an affirmative election to contribute to the PLESA would be an affirmative election to contribute to the CODA under the proposed rule. However, because automatic enrollment to contribute to a PLESA generally would not satisfy this investment requirement, automatic contributions to the PLESA could not be used to meet the §414A automatic enrollment requirements. 90 Fed. Reg. at 3100-01 (preamble to proposed rule).

[380] Prop. Reg. §1.414A-1(c)(1)(iii).

[381] Reg. §1.401(k)-1(e)(2).

[382] §3121(v)(1), §3306(r).

[383] *See* §3101(b), §3111(b), §3121(a)(1).

[384] See Reg. §1.401(k)-1(a)(3), defining a CODA by reference to a contribution.

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3. *Effect of a Qualified CODA on Other Retirement Plans*

It is normally advisable when establishing a qualified CODA to amend each retirement plan of the employer to define compensation, for purposes of computing contributions or benefits under the plan, in a manner that will not be affected by elections under the CODA. For example, if the CODA involves a salary reduction, compensation should generally be defined for retirement plan purposes as compensation before any reduction under the CODA. If the CODA involves elections as to a year-end bonus, each retirement plan of the employer should either include or exclude the entire bonus in all cases, without regard to the portion of the bonus deferred under the CODA.

If this approach is not taken, in general, participants in the CODA will be penalized for making deferral elections, or rewarded for electing cash rather than deferral, since their employer-provided contributions or benefits under the retirement plan in question will be smaller if they maximize their deferral election. Moreover, since CODA elections may change from year to year, or perhaps even month to month, the calculation of other retirement contributions and benefits would become more complicated if the cash or deferred elections were taken into account in determining compensation.

Note: The above approach is desirable not only in other retirement plans of the employer, but also in the plan that contains the qualified CODA if that plan also provides for nonelective employer contributions based upon compensation.

The approach suggested above of neutralizing the effect of cash or deferred elections on other retirement contributions or benefits has been approved by Congress in §414(s), and by the IRS in its regulations under §401(a)(4). Both the general tests and "safe harbors" for demonstrating nondiscriminatory allocations or accruals under those regulations are based upon compensation as defined in §414(s)[385] Under §414(s) an employer may include elective deferrals in its definition of compensation.[386]

Section 404(a)(12)[387] amends the definition of compensation for purposes of §404(a)(3) to include salary reduction amounts treated as compensation under §415(c)(3)(C) and §415(c)(3)(D). The definition of compensation for purposes of the SEP IRA deduction rules includes salary reduction amounts treated as compensation under §415.[388] Elective deferrals (as defined in §402(g)(3)) are not subject to the deduction limits, and the application of a deduction limit to any other employer contribution to a qualified retirement plan does not take into account elective deferral contributions.[389] Thus, elective deferrals made to a SEP IRA are not subject to the deduction limits and are not taken into account in applying the limits to other SEP IRA contributions.[390]

4. *Effect of a Qualified CODA on Group Term Life Insurance and Disability Benefits*

Other benefits, including group term life insurance and disability benefits, are often based upon the compensation of employees. Plans providing these benefits should normally be amended, when a qualified CODA is implemented, to clarify their definition of compensation, and to insulate benefits from the effects of elections under the CODA. To the extent these other benefit plans are subject to nondiscrimination requirements, the inclusion in compensation of elective contributions under the CODA should be permissible, even if §414(s) is not specifically referenced in the applicable provisions, for the same reason it is permitted under qualified retirement plans.[391]

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[385] *See generally* Reg. §1.401(a)(4)-1–§1.401(a)(4)-12.

[386] *See* IV.B.1.c., below.

[387] As amended by EGTRRA, Pub. L. No. 107-16, §616(a), effective for years beginning after December 31, 2001. Prior to 2002, elective deferrals under a qualified CODA could not be included in compensation for purposes of the deduction limits of §404(a). Thus, care had to be taken to limit the amount of salary reduction, and the amount of the elective contributions under the CODA, to avoid exceeding these limits, losing deductions, and incurring the excise tax of §4972.

[388] §404(a)(12), as amended by JCWAA, Pub. L. No. 107-147, §411(l)(1).

[389] §404(n), added by EGTRRA, Pub. L. No. 107-16, §614(a), effective for years beginning after December 31, 2001.

[390] §404(n), as amended by JCWAA, Pub. L. No. 107-147, §411(l)(2), effective for years beginning after December 31, 2001.

[391] *See* IV.B.2.d.(2), below.

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III. Section 401(k) and §401(m) Nondiscrimination Rules

Section 401(k) plans may not discriminate in favor of highly compensated employees ("HCEs").[392] Compliance with this requirement is demonstrated through a series of specific tests.

Different types of contributions under one plan (e.g., elective deferrals, matching contributions, etc.) are treated as separate plans for this purpose, and therefore tested separately.[393] In addition, the contribution types are subject to slightly different tests. Specifically, the following groups of contribution types are subject to different tests and each group is tested separately from the other groups: (i) elective deferrals, including Roth contributions;[394] (ii) after-tax employee contributions and matching contributions;[395] and (iii) all other contribution types (e.g., profit-sharing contributions).[396]

Discussed below are the nondiscrimination rules that apply to elective deferrals and the nondiscrimination rules that apply to matching contributions and after-tax employee contributions, with a focus on ADP and ACP testing. In each case, the nondiscrimination rules may not have to be satisfied if certain safe harbor conditions are met.

A. *Overview of Nondiscrimination Rules That Apply to Elective Contributions*

The nondiscrimination requirements that apply to elective contributions under a CODA can generally be broken down into two requirements: coverage testing under §410(b) and nondiscrimination testing under §401(a)(4).

First, the elective contributions must satisfy the coverage requirements of §410(b).[397] This generally means that a certain number or percentage of non-highly compensated employees ("non-HCEs") must benefit from the elective contributions. The requirements of §410(b) are discussed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*. However, when applying these requirements to elective contributions, generally employees who are eligible to make elective contributions are treated as employees who "benefit" under the arrangement, whether or not the employee elects to make any contribution.[398]

Second, the elective contributions must pass the nondiscrimination requirements of §401(a)(4). The §401(a)(4) requirements include what is frequently referred to as the nondiscriminatory amount requirement or "amounts testing." The exclusive means for elective contributions to meet §401(a)(4) amounts testing is for the elective contributions to pass the ADP or "actual deferral percentage" test.[399] The requirements of the ADP test are discussed in detail below. A plan that satisfies the safe harbor standards is generally deemed to satisfy the ADP test.[400] Safe harbor plans are discussed in IV., below.

In addition, all benefits, rights, and features of the elective contributions must meet the general nondiscrimination requirements under §401(a)(4), meaning that they must be available to a nondiscriminatory group.[401] Examples of benefits, rights, and features with respect to elective contributions include the right to make a certain level of elective contributions (e.g., up to 50% of compensation), and the ability to make Roth contributions.

> *Example:* A CODA limits elective contributions to a percentage of wages that are in excess of the Social Security wage base. Since highly compensated employees will be able to contribute a higher percentage of total compensation than non-highly compensated employees, the elective contributions will fail to comply with benefits, rights, and features portion of the general nondiscrimination rules of §401(a)(4).[402]

The specifics of determining whether each benefit, right, and feature is available to a nondiscriminatory group is discussed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*, and 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans.*

Practice Insight: The elective contribution coverage and nondiscrimination requirements are treated as satisfied with respect to a governmental plan.[403] In addition, elective contributions available to collectively bargained employees automatically satisfy the coverage requirements of §410(b) and the general nondiscrimination requirements of §401(a)(4).[404] However, the collectively bargained plan (or portion of the plan) must still pass the ADP test.[405] If not, while the plan will not fail to be qualified, the contributions would be taxable to the employees.

1. *Overview of the ADP Test*

Elective contributions must satisfy the ADP test.[406] There are two methods to satisfy the ADP test: the 1.25 test or the 2.0 test.[407] The 1.25 test is satisfied if the actual deferral percentage for the highly compensated employees is not more than 1.25 times the actual deferral percentage for non-highly compensated employees.[408] The 2.0 test is satisfied if the actual deferral percentage for the highly compensated employees is not more than twice the actual deferral percentage for non-highly compensated employees, and the difference between the percentages is not more than two percentage points.[409]

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[392] §401(a)(4), §401(k)(3).

[393] Reg. §1.410(b)-7(c).

[394] §401(k)(3); Reg. §1.401(k)-1(a)(4).

[395] §401(m); Reg. §1.401(m)-1(a)(1).

[396] §410(b), §401(a)(4).

[397] §401(k)(3)(A)(i). The statutory language in §401(k)(3)(A)(i) indicates that the CODA must satisfy the coverage test in §410(b)(1), which does not directly pick up the average benefit percentage test. Nonetheless, the IRS has indicated that a CODA may satisfy the average benefit percentage test, rather than the ratio percentage test. *See* Reg. §1.401(k)-1(b)(1)(i).

[398] §410(b)(6)(E).

[399] Reg. §1.401(a)(4)-1(b)(2)(ii).

[400] §401(k)(11), §401(k)(12), §401(k)(13), §414(x).

[401] Reg. §1.401(k)-1(a)(4)(iv)(B).

[402] Reg. §1.401(k)-1(a)(4)(iv)(B).

[403] §401(a)(5)(G), §410(c)(2), §401(k)(3)(G).

[404] Reg. §1.401(a)(4)-1(c)(5), §1.410(b)-2(b)(7).

[405] Reg. §1.401(k)-1(a)(5)(v), example illustrating a collectively bargained CODA that does not satisfy the ADP test and the interaction with general treatment of a collectively bargained plan as satisfying §401(a)(4).

[406] §401(k)(3)(A).

[407] §401(k)(3)(A).

[408] §401(k)(3)(A)(ii)(I).

[409] §401(k)(3)(A)(ii)(II).

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The actual deferral percentage for each group (HCEs and non-HCEs) is based on the actual deferral ratio ("ADR") for each employee. A participant's ADR is generally calculated by dividing the employee's elective deferrals (plus other eligible plan contributions) by the employee's compensation for the year.[410] In other words, the ADR is the percentage of an employee's compensation that has been contributed to the plan as elective contributions (and other eligible plan contributions) that year.

The actual deferral percentage for the highly compensated eligible employees is then calculated by averaging the individual ratios for all the highly compensated eligible employees.[411] The actual deferral percentage for non-highly compensated employees is calculated by averaging the individual ratios for all non-highly compensated employees. An employer may choose whether to use current year or prior year data when calculating the actual deferral percentage, but only for the non-highly compensated employees. See III.D., below, for a detailed discussion of current versus prior year data use for these purposes.

A plan will not be treated as satisfying the ADP test if there are repeated changes in plan testing procedures or plan provisions that have the effect of distorting the ADP test so as to increase significantly the permitted ADP for highly compensated employees and if a principal purpose of the changes was to achieve such a result.[412]

See below for more details and illustrations of the ADP test.

2. *Steps to Apply the ADP Test*

To apply the ADP test for a plan year, the following steps must be taken:

First, after taking into account the aggregation and disaggregation rules below, the employees who are eligible for the CODA (or in other words, eligible for elective contributions) are identified for the plan year.

Second, those eligible employees who are highly compensated are identified.

Third, an actual deferral ratio is computed for each highly compensated eligible employee, representing the elective contributions (and, where applicable, certain other contributions) taken into account for the plan year as a percentage of the employee's compensation for the plan year.

Fourth, the individual deferral ratios are averaged for the highly compensated employees. This average is referred to in the statute and regulations as the "actual deferral percentage" for the highly compensated employees, and is reported to the nearest hundredth of a percentage point.[413]

Fifth, the second, third, and fourth steps are followed with respect to the non-highly compensated employees. Subject to some limitations discussed below, current or prior year data may be used when taking these steps for non-highly compensated employees.

Practice Insight: Where the actual deferral percentage for the non-highly compensated employees is based on prior year data, that percentage will, in most cases, be determined as soon as practicable after the end of that prior year so that it will be available to help the employer monitor compliance with the ADP test throughout the current year.

B. *Overview of Nondiscrimination Rules That Apply to Matching and After-Tax Contributions*

Despite the very different character of matching and after-tax contributions, these two types of contributions are combined for purposes of nondiscrimination testing.[414] Together, matching contributions and after-tax contributions are referred to as a §401(m) plan. The §401(m) regulations refer to after-tax contributions as "employee" contributions.[415]

Like elective contributions under a CODA, matching contributions and after-tax employee contributions must generally satisfy two nondiscrimination requirements: coverage testing under §410(b) and nondiscrimination testing under §401(a)(4).

First, the group of employees who are eligible to make an after-tax contribution or to receive an allocation of matching contributions under the plan must satisfy the coverage requirements of §410(b).[416] This generally means that a certain number or percentage of non-highly compensated employees must benefit from the matching contributions and after-tax contributions. The rules and application of §410(b) are discussed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*. As in the case of elective contributions, when applying these rules to a §401(m) plan, employees who are eligible to make after-tax employee contributions or to receive matching contributions are generally treated as employees who "benefit" under the arrangement, whether or not the employee elects any after-tax contribution or receives a matching contribution.[417]

Second, the matching and after-tax contributions must pass the nondiscrimination requirements of §401(a)(4). The §401(a)(4) requirements include what is frequently referred to as the nondiscriminatory amount requirement or "amounts testing." The exclusive means for matching and after-tax contributions to meet §401(a)(4) amounts testing is for the contributions to pass the ACP or "actual contribution percentage" test.[418] The requirements of the ACP test are discussed in detail below. A plan that satisfies the safe harbor standards is generally deemed to satisfy the ACP test with respect to the matching contributions, but the safe harbor does not apply to after-tax contributions.[419] Safe harbor plans are discussed in IV., below.

Practice Insight: If a plan uses an ACP safe harbor, such plan may want to disallow any after-tax contributions in order to avoid running an ACP test.

In addition, all benefits, rights, and features of the matching contributions and after-tax contributions must meet the gen-

[410] Reg. §1.401(k)-2(a)(3)(i).

[411] §401(k)(3)(B); Reg. §1.401(k)-2(a)(2).

[412] Reg. §1.401(k)-1(b)(3).

[413] §401(k)(3)(B); Reg. §1.401(k)-2(a)(2).

[414] See I.D., above, for a discussion, and definitions of, the different contribution types.

[415] For an explanation of this nomenclature, see I.D., above.

[416] §401(k)(3)(A)(i). The statutory language in §401(k)(3)(A)(i) indicates that the CODA must satisfy the coverage test in §410(b)(1), which does not directly pick up the average benefit percentage test. Nonetheless, the IRS has indicated that a CODA may satisfy the average benefit percentage test, rather than the ratio percentage test. *See* Reg. §1.401(k)-1(b)(1)(i).

[417] §410(b)(6)(E).

[418] §401(m)(2); Reg. §1.401(m)-1(a)(1)(i).

[419] §401(m)(10), §401(m)(11), §401(m)(12), or §414(x).

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eral nondiscrimination requirements under §401(a)(4), meaning that they must be available to a nondiscriminatory group.[420]

> *Example 1:* A plan provides that all participants, other than senior management, will receive a 50% match on their elective contributions. Senior management will receive a 100% match.

> *Example 2:* A plan allows employees to contribute up to 10% of compensation as elective contributions. The plan further provides that, if any employee cannot contribute the full 10% of elective contributions because of the dollar limit of §402(g), the employee may contribute the difference on an after-tax basis.

Both the matching formula in *Example 1* and the limited availability of employee after-tax contributions in *Example 2* will cause each plan to fail the general nondiscrimination rules applicable to a plan's benefits, rights, and features under §401(a)(4).

The specifics of determining whether each benefit, right, and feature is available to a nondiscriminatory group are discussed in detail in 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*, and 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans.*

As in the case of elective contributions, the matching contribution and after-tax contribution nondiscrimination requirements are treated as satisfied with respect to a governmental plan.[421] Also, the requirements are treated as satisfied with respect to matching and after-tax contributions under a collectively bargained plan (or portion of a plan).[422] Thus, a collectively bargained plan that includes a CODA with a matching contribution generally must satisfy only the ADP test.

1. Overview of ACP Test

Matching and after-tax contributions must satisfy the ACP test.[423] There are two methods to satisfy the ACP test: the 1.25 test and the 2.0 test.[424]

The 1.25 test is satisfied if the actual contribution percentage for the highly compensated employees is not more than 1.25 times the actual contribution percentage for non-highly compensated employees.[425] The 2.0 test is satisfied if the actual contribution percentage for the highly compensated employees is not more than twice the actual contribution percentage for non-highly compensated employees, and the difference between the percentages is not more than two percentage points.[426]

The actual contribution percentage for each group (HCEs and non-HCEs) is based on the actual contribution ratio (ACR) for each employee. A participant's ACR is generally calculated by dividing the employee's matching and after-tax contributions (plus other eligible plan contributions) by the employee's compensation for the year.[427] In other words, the ACR is the percentage of an employee's compensation that has been contributed to the plan as matching or after-tax contributions (and other eligible contributions) that year.

The actual contribution percentage for the highly compensated eligible employees is then calculated by averaging the individual ratios for all the highly compensated eligible employees.[428] The actual contribution percentage for non-highly compensated employees is calculated by averaging the individual ratios for all non-highly compensated employees. An employer may choose whether to use current year or prior year data when calculating the actual contribution percentage, but only for the non-highly compensated employees. See III.D., below, for a detailed discussion of current versus prior year data use for these purposes.

A plan will not be treated as satisfying the ACP test if there are repeated changes in plan testing procedures or plan provisions that have the effect of distorting the ACP test so as to increase significantly the permitted ADP for highly compensated employees and if a principal purpose of the changes was to achieve such a result.[429]

See below for more details and illustrations of the ACP test.

2. Steps to Apply the ACP Test

To apply the ACP test for a plan year, the following steps must be taken:

- First, after taking into account the aggregation or disaggregation rules discussed below, the employees who are eligible for matching or after-tax contributions are identified for the plan year.
- Second, those eligible employees who are highly compensated are identified.
- Third, an actual contribution ratio is computed for each highly compensated eligible employee, representing the matching and after-tax contributions (and, where applicable, certain other contributions) taken into account for the plan year as a percentage of the employee's compensation for the plan year.
- Fourth, the individual contribution ratios are averaged for the highly compensated eligible employees. This average is referred to in the statute and regulations as the "actual contribution percentage" for the highly compensated employees, and is reported to the nearest hundredth of a percentage point.
- Fifth, the second, third, and fourth steps are followed with respect to the non-highly compensated employees. Subject to some limitations discussed below, current or prior year data may be used when taking these steps for non-highly compensated employees.

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420 Reg. §1.401(a)(4)-4(e)(3)(iii)(F), §1.401(a)(4)-4(e)(3)(iii)(G), §1.401(m)-1(a)(1)(ii).

421 §401(a)(5)(G), §410(c)(2), §401(k)(3)(G).

422 Reg. §1.401(m)-1(b)(2); *see* Reg. §1.401(a)(4)-1(c)(5), §1.410(b)-2(b)(7).

423 §401(m)(1).

424 §401(m)(2)(A). Note that the 1.25 and 2.0 tests are expressed as percentages (i.e., 125% and 200%) in the statute, but they operate mathematically in the same manner as the 1.25 and 2.0 ADP tests.

425 §401(m)(2)(A)(i).

426 §401(m)(2)(A)(ii).

427 Reg. §1.401(m)-2(a)(3)(i).

428 §401(m)(3); Reg. §1.401(m)-2(a)(2).

429 Reg. §1.401(m)-1(b)(3).

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Practice Insight: Where the actual contribution percentage for the non-highly compensated employees is based on prior year data, that percentage will, in most cases, be determined as soon as practicable after the end of that prior year so that it will be available to help the employer monitor compliance with the ACP test throughout the current year.

C. Identifying, Aggregating and Disaggregating Plans and Plan Components for Purposes of 401(k) Plan Nondiscrimination Testing

The coverage and nondiscrimination requirements generally work from the premise that each plan is tested separately. A "plan" for these purposes is each single plan within the meaning of §414(l).[430] In general, a single plan exists for §414(l) purposes where a pool of assets is available to pay any benefits provided under the plan.[431]

However, for purposes of applying the 401(k) and 401(m)-specific coverage and nondiscrimination rules, some plans and plan components must be, or can be, aggregated or disaggregated.

1. Disaggregation of Plan Components for Purposes of 401(k) Plan Nondiscrimination Testing

Certain plan components are required to be tested separately (known as mandatory disaggregation). In some instances, disaggregation is optional. Generally, the same disaggregation rules that apply for purposes of §410(b) coverage testing also apply for purposes of applying the 401(k) and 401(m)-specific coverage and nondiscrimination rules,[432] although there are certain exceptions.[433]

The following plan components are disaggregated, and tested separately:

(1) As described in the introduction to this section, different contributions types are disaggregated, treated as separate plans, and tested separately (e.g., elective contributions are tested separately from matching and after-tax contributions).[434] However, for purposes of ADP and ACP testing, this disaggregation rule does not technically apply, as elective contributions may in some instances be taken into account for purposes of the ACP test, and matching contributions may be taken into account in some instances for purposes of the ADP test.[435] See III.H. and III.I., below, for discussions of the contributions that may be taken into account for purposes of the ADP and ACP tests.

(2) The portion of a plan that is an ESOP is generally treated as a separate plan from the portion that is not an ESOP.[436] However, the employer may elect to treat an ESOP and a non-ESOP as a single plan.[437]

Practice Insight: The ability to aggregate the ESOP and non-ESOP portions of a plan for testing is helpful for plans that define the portion of the plan that permits investments in an employer stock fund as an ESOP. This approach is common in order to maximize deductions on dividends paid on employer securities that are held in an ESOP under §404(k).

(3) To the extent a plan benefits employees who are covered by a collective bargaining agreement and employees who are not, the plan is generally treated as separate plans: one covering the collectively bargained employees, and one covering the non-collectively bargained employees.[438] In addition, to the extent a plan benefits groups of employees who are included in separate collective bargaining units, the plan is treated as separate plans, each one covering a separate collective bargaining unit. However, for purposes of ADP testing, the employer can elect to treat two or more collective bargaining units as a single unit for this purpose, on a basis that is reasonable and reasonably consistent from year to year.[439]

Practice Insight: This does not apply for purposes of ACP testing because no ACP test is required for collectively bargained employees.[440]

(4) If disaggregated for purposes of §410(b) coverage testing, the portion of the plan that benefits employees that could be excluded from the plan because they have not met the I.R.C. minimum age and service requirement ("excludible employees") is treated as a separate plan.[441] For purposes of the ADP and ACP tests, the employer may choose to go one step further and run the tests disregarding the non-highly compensated excludible employees.[442] Long-term, part-time employees required to be offered participation in the plan may also be excluded for the purpose of all coverage and nondiscrimination testing as well.[443]

Practice Insight: Thus, the fact that employees who have less than one year of service will tend to have lower deferral rates and would otherwise adversely affect testing should not be a bar to allowing immediate entry into a plan.

(5) If an employer is treated as operating qualified separate lines of business under §414(r), and a plan benefits employees of more than one such line of business, the portion of the plan that benefits employees of that qualified separate line of business is treated as a separate plan unless the employer is applying the special rule for employer-

[430] *See* Reg. §1.410(b)-7(b), referenced by Reg. §1.401(k)-1(b)(4)(iii).
[431] Reg. §1.414(l)-1(b)(1).
[432] Reg. §1.401(k)-1(b)(4)(iii), §1.401(m)-1(b)(4)(iii).
[433] Reg. §1.401(k)-1(b)(4)(v), §1.401(m)-1(b)(4)(v).
[434] Reg. §1.410(b)-7(c)(1).
[435] Reg. §1.401(k)-1(b)(4)(v)(A).
[436] Reg. §1.410(b)-7(c).
[437] Reg. §1.401(k)-1(b)(4)(v)(A), §1.401(m)-1(b)(4)(v).
[438] Reg. §1.410(b)-7(c).
[439] Reg. §1.401(k)-1(b)(4)(v)(B).
[440] Reg. §1.401(m)-1(b)(2).
[441] Reg. §1.410(b)-7(c)(3), §1.401(k)-1(b)(4)(iv)(A), §1.401(m)-1(b)(4)(iv)(A).
[442] §401(k)(3)(F); Reg. §1.401(k)-2(a)(1)(iii)(A), §1.401(m)-2(a)(1)(iii)(A).
[443] §401(k)(15)(B)(i)(II), added by the SECURE Act of 2019, Pub. L. No. 116-94, Div. O, §112, and amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §125(a)(2)(B). *See* Prop. Reg. §1.401(k)-5(f)(1), REG-104194-23, 88 Fed. Reg. 82,796 (Nov. 27, 2023).

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wide plans in Reg. §1.414(r)-1(c)(2)(ii) with respect to the plan.[444]

(6) A multiple employer plan is treated as comprising separate plans, each maintained by each separate employer.[445]

(7) Effective for contributions made for plan years that begin on or after January 1, 2024, if a plan makes a matching contribution on behalf of an employee on account of a qualified student loan payment, the plan may disaggregate the group that receives such matching contribution for the plan year for purposes of applying the ADP test.[446]

Other than as described above, plans may not be permissively disaggregated for purposes of applying the 401(k) and 401(m)-specific coverage and nondiscrimination rules.

For plan years beginning before January 1, 1992, a single plan could be divided into "component plans" for coverage and nondiscrimination testing purposes.[447] Under this technique, commonly referred to as "restructuring," separate coverage and nondiscrimination tests were applied to each component plan as if it were a separate plan. For plan years beginning after December 31, 1991, restructuring is not permissible.[448]

Practice Insight: The prohibition against restructuring is limited to components of a single plan. There is no prohibition against establishing separate §401(k) plans, in which case the ADP and ACP tests would be performed separately for each plan, provided that each plan meets the minimum coverage and nondiscrimination tests. However, the more §401(k) plans that an employer or a controlled group sponsor, the more difficult it becomes to meet the requirements of §410(b) coverage testing.

2. *Aggregation of Plans for Purposes of 401(k) Plan Nondiscrimination Testing*

An employer may designate two or more separate plans (other than plan or plan components required to be treated as separate plans in III.C.1., above) as a single plan for purposes of coverage and nondiscrimination testing, including ADP and ACP testing.[449] However, it is important to note that if a plan is aggregated for purposes of ADP or ACP testing, it must also be aggregated for purposes of §410(b) coverage testing and §401(a)(4) nondiscrimination testing, and vice versa.[450]

Example 1: An employer maintains two separate CODAs under separate plans, one for salaried employees and one for hourly employees. The employer treats the two plans as a single plan for purpose of passing §410(b), coverage testing. In that case, it must also treat the two CODAs as a single CODA for purposes of ADP and ACP testing.

A plan cannot be combined with two or more plans to form more than one single plan for purposes of testing.[451]

Example 2: Two separate subsidiaries of a corporation maintain CODAs under separate plans, for roughly proportionate numbers of highly compensated and non-highly compensated employees. One satisfies the ADP test with ease; the other satisfies it with difficulty, and sometimes needs to correct a failed ADP test. The two plans satisfy the coverage requirements of §410(b) both separately and taken together. The employer elects to combine them for coverage and nondiscrimination purposes, including ADP testing. On a combined basis, the plans may have no difficulty satisfying the ADP test.

Plans must have the same plan year in order to be aggregated.[452]

Where a plan is a multiemployer plan under §413(b), the portion of the plan maintained pursuant to a collective bargaining agreement is treated as a single plan maintained by a single employer that employs all employees benefiting under the same benefit computation formula and covered pursuant to the same collective bargaining agreement.[453]

3. *Aggregation of Plan Components for ADP and ACP Testing*

For purposes of ADP testing, all CODAs provided under a single plan must be treated as a single CODA.[454] For purposes of ACP testing, all matching contributions and after-tax contributions must be subject to one ACP test.[455] For example, if a single plan is maintained under which separate CODAs, with different features, are available to different groups of employees, all of the CODAs must be aggregated for purposes of applying the §401(k)(3)-specific coverage and nondiscrimination rules.[456] The same is true of CODAs in separate plans that must be combined to satisfy §410(b) coverage testing.[457]

Practice Insight: This means, among other things, that a single testing method must apply to the §401(k) or §401(m) arrangements — i.e., ADP/ACP testing versus safe harbor treatment, and current year versus prior year testing.[458]

Example: A parent corporation and its subsidiary, which are in the same controlled group, have separate CODAs. A greater percentage of the parent's employees are highly compensated than those of the subsidiary, and the CODAs must be combined to satisfy §410(b) coverage testing. Looking at each plan alone in a given year, the actual deferral percentages for the highly compensated employ-

[444] Reg. §1.401(k)-1(b)(4)(iv), §1.401(m)-1(b)(4)(iv), §1.410(b)-7(c)(4)(i), §1.410(b)-7(c)(4)(ii)(A).

[445] Reg. §1.401(k)-1(b)(4)(iii), §1.410(b)-7(c)(4)(i), §1.410(b)-7(c)(4)(ii)(C).

[446] §401(m)(13)(B)(iv), added by Pub. L. No. 117-328, Div. T, §110(c), effective for contributions made for plan years beginning after December 31, 2023. *See* Notice 2024-63, Q&A D-1 (providing for and comparing two methods for separate testing for employees who receive qualified student loan payment matches). See II.F.1.c., above, for discussion of the qualified student loan payment match feature.

[447] Pre-2006 Reg. §1.401(k)-1(h)(3)(iii).

[448] Reg. §1.401(k)-1(b)(4)(iv)(B).

[449] Reg. §1.401(k)-1(b)(4)(iii)(A), §1.401(m)-1(b)(4)(iii)(A), §1.410(b)-7(d).

[450] Reg. §1.410(b)-7(d).

[451] Reg. §1.410(b)-7(d)(3).

[452] Reg. §1.410(b)-7(d)(5).

[453] Reg. §1.401(k)-1(b)(4)(v)(C).

[454] Reg. §1.401(k)-1(b)(4)(ii).

[455] Reg. §1.401(m)-1(b)(4)(ii).

[456] Reg. §1.401(k)-1(b)(4)(ii).

[457] Reg. §1.401(k)-1(b)(4)(ii).

[458] Reg. §1.401(k)-1(b)(4)(iii)(B).

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ees and non-highly compensated employees in the parent company plan are 12.5% and 10%, respectively. Under the subsidiary's plan, the actual deferral percentages are 4% and 2%, respectively, for the highly compensated employees and non-highly compensated employees. While each plan alone satisfies the 1.25 test or 2.0 test, on a combined basis the actual deferral percentages might be, e.g., 10% for highly compensated employees and 4% for the non-highly compensated employees. In that event, neither arrangement satisfies the ADP test.

4. *Aggregation of Plan Components When Computing Deferral and Contribution Percentages for Highly Compensated Employees*

If any highly compensated employee participates in two or more CODAs of the same employer (including employers within a controlled group), the employee's deferral percentage shall be computed by treating the CODAs as if they were a single CODA.[459] The same is true of highly compensated employees that participate two or more plans that provide for matching or after-tax contributions.[460] These rules were presumably intended to prevent employers from breaking up plans into two or more separate plans in order to allow each arrangement to satisfy the ADP and ACP tests.

Example: Before establishing a CODA, an employer ascertains from discussions with its employees that the actual deferral percentage for the highly compensated employees is likely to be 8% and the actual deferral percentage for the non-highly compensated employees is likely to be 4%. Instead of establishing one CODA, the employer establishes two arrangements, under which elective deferrals are to be made pro rata. Under each arrangement, the actual deferral percentage for the highly compensated employees is expected to be 4%, and the actual deferral percentage for the non-highly compensated employees is expected to be 2%, satisfying the 2.0 test in each case. However, the deferral percentages for the highly compensated employees must be computed by treating the CODAs as a single CODA, resulting in an actual deferral percentage of 8% under each CODA for the highly compensated employees. Thus, neither CODA would satisfy the 1.25 or 2.0 test.

Note: The statute requires the CODAs to be treated as a single CODA only for purposes of computing the actual deferral percentage for the highly compensated employees, and not for purposes of computing the actual deferral percentage for non-highly compensated employees.

Example: If the percentages in the foregoing example were multiplied by one-half, combining the CODAs for all purposes would result in compliance with the 2.0 test, because the actual deferral percentages would be 4% for the highly compensated employees and 2% for the non-highly compensated employees. Combining the CODAs solely for purposes of computing the actual deferral percentage for the highly compensated employees results in actual deferral percentages of 8% and 2%, respectively, under each CODA, which would fail to satisfy either the 1.25 or the 2.0 test. While the statutory provision seems broader than necessary to prevent the abuse that concerned Congress, it would be unusual for an employer to maintain two CODAs covering the same employees.

Plans that are not permitted to be aggregated under Reg. §1.410(b)-7(c) (see III.C.1., above, for a description) are not aggregated as to highly compensated employees.[461]

Contributions under separate §401(k) or §401(m) arrangements must be aggregated for the same period as the plan year of the plan being tested.[462]

5. *Section 401(k) Plan Nondiscrimination Testing During and After Mergers, Acquisitions, Etc.*

The statute, regulations, and legislative history do not address whether, and to what extent, aggregation is required where an employer maintaining a §401(k) plan acquires another employer maintaining a §401(k) plan and the second §401(k) plan is either terminated or merged into the first in the middle of the plan year. Query whether each plan should be tested separately for the portion of the plan year in which it is separate, or whether the employer would have the option of testing them on a combined basis for the entire plan year, taking into account compensation from, and contributions by, the predecessor employer. Alternatively, it may be easier in a given case to segregate the employee groups within the combined plan and test each group separately for the entire plan year.

In 2000, the IRS indicated that it was in the process of developing guidance on the application of the §401(k) and §401(m) nondiscrimination testing requirements in situations where the entity sponsoring a §401(k) plan is involved in a merger, acquisition, disposition or other similar transaction, and requested comments from interested stakeholders.[463] The post-2005 regulations, however, do not provide guidance on these issues and it appears that the IRS is no longer actively developing guidance on mergers and acquisitions issues.

D. *Current Year or Prior Year Testing Method for Purposes of ADP and ACP Testing*

When calculating the actual deferral percentage and actual contribution percentage for non-highly compensated employees, an employer may choose to use the prior year's actual deferral percentage and/or the actual contribution percentage for the non-highly compensated employees.[464] This is referred to as the prior year testing method. If an employer chooses to use the current year's actual deferral percentage and/or the actual contribution percentage for the non-highly compensated employees, it is referred to as the current year testing method.

Practice Insight: By using the prior year's information for testing, employers may be able to limit contributions on behalf

[459] §401(k)(3)(A).
[460] §401(m)(2)(B).

[461] Reg. §1.401(k)-2(a)(3)(ii)(B).
[462] Reg. §1.401(k)-2(a)(3)(ii)(A), §1.401(m)-2(a)(3)(ii)(A).
[463] Notice 2000-3.
[464] §401(k)(3)(A)(ii), §401(m)(2)(A).

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of or by highly compensated employees in advance, making it less likely that the plan will fail the ADP test.

If an employer chooses to use the prior year testing method, for the first plan year, when there is no prior year data, the employer may choose to use 3% as the actual deferral percentage and actual contribution percentage of the non-highly compensated eligible employees, or may use current year data.[465] The first plan year of any plan is the first year in which the plan provides for elective contributions, or employee after-tax or matching contributions, as applicable.[466] However, a plan does not have a first plan year if during such plan year the plan is aggregated with any other plan in the prior year for purposes of the ADP or ACP test.[467]

A plan can utilize the prior year actual deferral percentage or actual contribution percentage for non-highly compensated employees regardless of any changes to the number or identity of non-highly compensated employees from the prior year to the current year.[468]

> *Example:* A plan uses the prior year testing method. If an employee is a non-HCE in 2020, and then becomes an HCE in 2021, the employee's 2020 data would still be taken into consideration for purposes of calculating the non-HCE ADP to be utilized in 2021 testing.

There is no requirement that an employer's election to use the prior or current year testing method be consistent for both ADP and ACP tests.[469] However, plans that use different testing methods for ADP and ACP purposes cannot correct excess elective contributions via recharacterization,[470] count elective contributions under the ACP test rather than the ADP test,[471] or take into account qualified matching contributions under the ADP test rather than the ACP test.[472] In any event, it is unlikely that an employer would choose to use the prior year testing method for one purpose but not the other.

1. *Changing Between Current and Prior Year Testing Methods*

A plan is permitted to change from the prior year testing method to the current year testing method for any plan year.[473] However, a plan can only change from the current year testing method to the prior year testing method, in the following three situations:

(1) 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 five plan years preceding the plan year of the change (or if less, the number of plan years the plan has been in existence, including years in which the plan was a portion of another plan); or

(2) the plan is the result of the aggregation of two or more plans, and for each of the plans that are being aggregated, the current year testing method was used for each of the five plan years preceding the plan year of the change (or if less, 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); or

(3) an entity becomes or ceases to be a member of a controlled group, and qualifies for certain relief from the §410(b) coverage testing requirements; and 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 the change from the current year testing method to the prior year testing year method occurs within the period beginning on the date of the change in members of a group and ending on the last day of the first plan year beginning after the date of the change the transition period described in §410(b)(6)(C)(ii).[474]

For purposes of changing testing method, a plan that uses a design-based safe harbor, or a SIMPLE 401(k) plan, is treated as using the current year testing method.[475]

Practice Insight: If a design-based safe harbor plan or a SIMPLE 401(k) plan is tested for ADP or ACP, the plan must utilize the current year testing method, unless one of the above three situations applies.

See III.H.3., below, for a discussion of issues that arise when a plan changes from current year to prior year testing.

The regulations under §401(k) and §401(m) include an anti-abuse provision in which a plan will not be treated as satisfying the ADP or ACP test if there are "repeated changes to plan testing procedures or plan provisions that have the effect of distorting the [ADP/ACP] so as to increase significantly the permitted [ADP/ACP] for [highly compensated employees], or otherwise manipulate the nondiscrimination rules … , if a principal purpose of the changes was to achieve such a result."[476]

2. *Plan Coverage Changes Affect Prior Year ADP and ACP Testing*

If there is a "plan coverage change" (defined below) during the testing year, a plan that otherwise uses the prior year testing method must use a weighted average as the ADP and ACP for the non-HCEs.[477]

A "plan coverage change" is a change in the group or groups of eligible employees under a plan due to:

(1) the establishment or amendment of a plan;

(2) a plan merger or spinoff under §414(l);

[465] §401(k)(3)(E); Reg. §1.401(k)-2(c)(2); §401(m)(3) (referring to §401(k)(3)(E)); Reg. §1.401(m)-2(c)(2). A successor plan is not eligible for this first-plan-year rule, and is considered to have a "plan coverage change" as described in III.D.2., above. A plan is considered a successor plan for this purpose if 50% or more of the eligible employees for the first plan year were eligible employees under a plan maintained by the employer in the prior year that provides for elective deferrals or matching contributions. Notice 98-1; Reg. §1.401(k)-2(c)(2)(iii), §1.401(m)-2(c)(2)(iii).

[466] Reg. §1.401(k)-2(c)(2)(ii), §1.401(m)-2(c)(2)(ii).

[467] Reg. §1.401(k)-2(c)(2)(ii), §1.401(m)-2(c)(2)(ii).

[468] Reg. §1.401(k)-2(a)(2)(ii), §1.401(m)-2(a)(2)(ii); *see* Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 104th Congress (Dec. 18, 1996) (1996 Bluebook) at 151.

[469] Reg. §1.401(k)-2(c)(3): Reg. §1.401(m)-2(c)(3).

[470] As permitted under Reg. §1.401(k)-2(b)(3).

[471] As permitted under Reg. §1.401(m)-2(a)(6)(ii).

[472] As permitted under Reg. §1.401(k)-2(a)(6).

[473] Reg. §1.401(k)-2(c)(1)(i), §1.401(m)-2(c)(1)(i).

[474] Reg. §1.401(k)-2(c)(1)(ii), §1.401(m)-2(c)(1) (incorporating by reference Reg. §1.401(k)-2(c)(1)(ii)).

[475] Reg. §1.401(k)-2(c)(1)(i), §1.401(m)-2(c)(1).

[476] Reg. §1.401(k)-1(b)(3), §1.401(m)-1(b)(3).

[477] Reg. §1.401(k)-2(c)(4)(i), §1.401(m)-2(c)(4)(i).

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(3) a change in the way plans are combined or separated for purposes of ADP or ACP testing (e.g., permissively aggregating plans not previously aggregated, or ceasing to permissively aggregate plans);

(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); or

(5) a combination of any of the foregoing.[478]

If a plan experiences a plan coverage change, the prior year ADP or ACP for non-highly compensated employees is the "weighted average of the ADPs" or the "weighted average of the ACPs," as applicable, for the "prior year subgroups."[479]

"Prior year subgroup" means all non-highly compensated employees for the prior year who, in the prior year, were eligible employees under a §401(k) plan or §401(m) plan, as applicable, 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 year instead of first being effective during the testing year.[480] The "weighted average of the ADPs for the prior year subgroups" is defined as the sum, for all prior year subgroups, of the "adjusted ADPs."[481] The "weighted average of the ACPs for the prior year subgroups" is defined as the sum, for all prior year subgroups, of the "adjusted ACPs."[482] "Adjusted ADP" or "Adjusted ACP" means, with respect to a prior year subgroup, the ADP or ACP, as applicable, for the prior 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 non-highly compensated employees in the prior year subgroup and the denominator of which is the total number of non-highly compensated employees in all prior year subgroups.[483]

However, if a plan is affected by a plan coverage change, and 90% or more of the total number of non-highly compensated employees from all prior year subgroups are from a single prior year subgroup, then in determining the ADP or ACP for non-highly compensated employees for the prior year, an employer may elect to use the ADP or ACP, as applicable, for non-highly compensated employees for the prior year of the plan under which that single prior year subgroup was eligible, in lieu of using a weighted average.[484]

Example: Assume Employer B maintains two plans, Plan O and Plan P, each of which includes a CODA. The plans were not permissively aggregated for the 2020 testing year. Both plans use the prior year testing method. Plan O had 300 eligible employees who were non-highly compensated employees for 2020, and their ADP for that year was 6%. Plan P had 100 eligible employees who were non-highly compensated employees for 2020, and the ADP for those non-highly compensated employees for that plan was 4%. Plan O and Plan P are permissively aggregated for the 2021 plan year.

The permissive aggregation of Plan O and Plan P for the 2021 testing year is a plan coverage change that results in treating the plans as one plan (Plan OP) for purposes of ADP testing. Therefore, the prior year ADP for non-highly compensated employees under Plan OP for the 2021 testing year is the weighted average of the ADPs for the prior year subgroups.

The Plan O prior year subgroup consists of the 300 employees who, in the 2020 plan year, were eligible non-highly compensated employees under Plan O and who would have been eligible under Plan OP for the 2020 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 2020 plan year, were eligible non-highly compensated employees under Plan P and would have been eligible under Plan OP for the 2020 plan year if Plan O and Plan P had been permissively aggregated for that plan year.

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 non-highly compensated employees under Plan O for the prior year) × 300/400 (the number of non-highly compensated employees in that prior year subgroup divided by the total number of non-highly compensated employees in all prior year subgroups), which equals 4.5%. The adjusted ADP for the Plan P prior year subgroup is 1%, calculated as follows: 4% (the ADP for the non-highly compensated employees under Plan P for the prior year) × 100/400 (the number of non-highly compensated employees in that prior year subgroup divided by the total number of non-highly compensated employees in all prior year subgroups), which equals 1%. Thus, the prior year ADP for non-highly compensated employees under Plan OP for the 2021 testing year is 5.5% (the sum of adjusted ADPs for the prior year subgroups, 4.5% plus 1%).

Suppose 60 of the eligible employees who were non-highly compensated employees for the 2020 plan year under Plan O terminated their employment during that year. The determination of whether a non-highly compensated employee is a member of a prior year subgroup is made without regard to whether that employee terminated employment during the prior year.[485] Thus, the prior year ADP for the non-highly compensated employees under Plan OP for the 2021 plan year is unaffected by the termination of the 60 non-highly compensated employees covered by Plan O during the 2020 plan year.[486]

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[478] Reg. §1.401(k)-2(c)(4)(iii)(A), §1.401(m)-2(c)(4)(iii)(A).

[479] Reg. §1.401(k)-2(c)(4(i), §1.401(m)-2(c)(4)(i).

[480] Reg. §1.401(k)-2(c)(4)(iii)(B), §1.401(m)-2(c)(4)(iii)(B). Termination of employment in the prior year is disregarded for this purpose.

[481] Reg. §1.401(k)-2(c)(4)(iii)(C).

[482] Reg. §1.401(m)-2(c)(4)(iii)(C).

[483] Reg. §1.401(k)-2(c)(4)(iii)(C), §1.401(m)-2(c)(4)(iii)(C).

[484] Reg. §1.401(k)-2(c)(4)(ii), §1.401(m)-2(c)(4)(ii).

[485] Reg. §1.401(k)-2(c)(4)(iii)(B).

[486] Reg. §1.401(k)-2(c)(4)(iv) *Ex.* 1. *See* Reg. §1.401(k)-2(c)(4)(iv) *Exs.* 2, 3, and 4 for additional examples of how the rules apply to the ADP test and see

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3. *Required ADP and ACP Plan Provisions*

A plan that relies on ADP or ACP testing (as opposed to a safe harbor) will not meet the qualification requirements unless it provides that the ADP or ACP test, as applicable, will be met and specifies whether it is using the prior year or current year testing method.[487] If the employer changes the testing method, the plan must be amended to reflect the change. Further, if the first-plan-year rule described above in III.D. applies, the plan must specify how the rule will be applied (i.e., whether the non-highly compensated employees' ADP or ACP will be 3% or whether the plan will use current-year data to calculate the non-highly compensated employees' ADP or ACP).[488]

E. *Identifying Eligible Employees for ADP and ACP Testing*

In order to apply the ADP and ACP tests, the employer must first identify eligible employees.

For purposes of the ADP test, those employees who are directly or indirectly eligible to make a cash or deferred election for any portion of the plan year are considered eligible employees.[489] For purposes of the ACP test, those employees who are eligible to make after-tax employee contributions or to receive a matching contribution under the plan being tested (for example, because they are eligible to make elective contributions that would be matched) are considered eligible employees.[490]

Employees who need only to sign an application or salary reduction agreement in order to participate, even if the employee has not done so, are considered eligible employees. In addition, an employee who is suspended from elective, matching, or employee after-tax contributions due to a loan, a distribution, an election not to participate, or application of the §415(c) limit is nevertheless considered to be an eligible employee for purposes of the ADP and ACP tests during the suspension period if he or she would otherwise be eligible.

An employee is not an eligible employee however if, upon commencing employment, or upon first becoming eligible under any plan of the employer, he or she had a one-time opportunity to elect — and has elected — not to be eligible for the plan or such contributions under any current or future plan of the employer. If the employee has not met the plan's minimum age and service requirements, he or she is not an eligible employee. In addition, long-term, part-time employees required to be offered participation in the plan for the purpose of making elective contributions may also be excluded for the purpose of all coverage and nondiscrimination testing.[491]

F. *Identifying Highly Compensated Employees for ADP and ACP Testing*

An employee is a "highly compensated employee" for the plan year if the employee:

(1) was a 5% owner at any time during the plan year or the preceding plan year; or

(2) had compensation for the preceding plan year from the employer in excess of $80,000, indexed for inflation.[492]

At the election of the employer, the group of employees described in (2) above may be further limited to those who are in the "top-paid group" for the preceding year (the highest paid 20% of the employees based on compensation paid during that year).[493] An employer's election to impose the "top-paid group" restriction can be made on a year-by-year basis, without the consent of the IRS.[494]

Practice Insight: The "top-paid group" election is often made if a plan is having difficulty passing the ADP or ACP tests, and needs to further limit the number of HCEs.

It is possible for a plan to cover only highly compensated employees, or no highly compensated employees at all. In the former event, the ADP and ACP tests are deemed to be satisfied.[495] When a plan covers only non-highly compensated employees, the tests are automatically satisfied by operation. In either case, however, the regulations still require a plan to provide by its terms that the ADP and ACP tests will be met.[496]

1. *Five-Percent Owner Determination for ADP and ACP Testing*

In the case of a corporate employer, the term 5% owner means any person owning "more than 5% of the outstanding stock of the corporation or stock possessing more than 5% of the total combined voting power of all stock of the corporation."[497] If the employer is not a corporation, a 5% owner is "any person who owns more than 5% of the capital or profits interest in the employer."[498] If an individual is a 5% owner on any day during the plan year or the preceding plan year, the individual will be considered a highly compensated employee for such plan year.[499]

Practice Insight: The term "5% owner" is misleading, in the sense that it does not include any individual owning precisely 5% of the stock (or capital or profits interest) of the employer. The individual must own *more than* 5% to be a "5% owner" for these purposes.

For purposes of identifying 5% owners of a corporation, an individual is treated as owning not only stock held directly

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Reg. §1.401(m)-2(c)(4)(iv) *Ex.* 1 for an example of the parallel rules applicable to the ACP test.

[487] Reg. §1.401(k)-1(e)(7), §1.401(m)-1(c)(2).

[488] Reg. §1.401(k)-1(e)(7), §1.401(m)-1(c)(2).

[489] Reg. §1.401(k)-6.

[490] §401(m)(5)(A); Reg. §1.401(m)-5.

[491] §401(k)(15)(B)(i)(II), added by Pub. L. No. 116-94, Div. O, §112, and amended by Pub. L. No. 117-328, Div. T, §125(a)(2)(B). *See* Prop. Reg. §1.401(k)-5(f)(1), REG-104194-23, 88 Fed. Reg. 82,796 (Nov. 27, 2023).

[492] Reg. §1.401(k)-6, §1.401(k)-5; §414(q)(1). For the current and historic dollar amounts, see the Worksheets. The IRS has released informal guidance, including examples, on its website on how to determine HCEs for an initial plan year and a short plan year. *See* https://www.irs.gov/retirement-plans/identifying-highly-compensated-employees-in-an-initial-or-short-plan-year.

[493] §414(q)(3).

[494] Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 104th Congress (Dec. 18, 1996) (1996 Bluebook), at 147.

[495] Reg. §1.401(k)-2(a)(1)(ii), §1.401(m)-2(a)(1)(ii).

[496] Reg. §1.401(k)-1(e)(7), §1.401(m)-1(c)(2).

[497] §414(q)(2), §416(i)(1)(B)(i)(I); Reg. §1.416-1, Q&A-T-17.

[498] §414(q)(2), §416(i)(1)(B)(i)(II).

[499] §414(q)(1)(A).

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but also stock held by certain related persons, to the extent that stock is attributed to the individual under §318.[500] Similarly, for noncorporate employers, the §318 attribution rules apply, substituting "capital or profits interest" for "stock" throughout §318.[501] In either case, the attribution rules are broadened by substituting 5% for 50% in §318(a)(2)(C).[502]

In determining ownership percentage of the employer, however, related employers are not aggregated under the controlled group rules of §414(b), §414(c), or §414(m).[503]

2. *Compensation Threshold and Definition for Determining Highly Compensated Employees for ADP and ACP Testing*

The second category of highly compensated employees is based on compensation of the employee for the preceding year,[504] also referred to as the "look-back year." The indexed compensation threshold for the look-back year applies when determining whether an employee is an HCE for the plan year.[505]

> *Example:* A calendar year plan is determining the highly compensated employees for its 2024 ADP testing. The indexed compensation threshold for 2024 is $155,000 and for 2023 is $150,000. If an employee's compensation was more than $150,000 in 2023, the employee would be considered a highly compensated employee for 2024 ADP testing purposes.
>
> For non-calendar year plans, the indexed compensation threshold for the calendar year in which the look-back period begins applies when determining whether an employee is an HCE for the plan year, not the compensation threshold for the calendar year in which the look-back period ends.[506]

> *Example:* A plan with a July 1–June 30 plan year is determining highly compensated employees for its July 1, 2024–June 30, 2025, ADP testing. The indexed §414(q)(1)(B) compensation threshold for 2024 is $155,000 and for 2023 is $150,000. The look-back year for this purpose is July 1, 2023–June 30, 2024. If an employee's compensation was more than $150,000 from July 1, 2023–June 30, 2024, the employee would be considered a highly compensated employee for the July 1, 2024–June 30, 2025, plan year for ADP testing purposes.
>
> For a non-calendar year plan, an employer can elect to treat the calendar year beginning within the look-back year as the look-back year ("calendar year data election"). Such an election, once made, applies to all subsequent years unless changed by the employer.

> *Example:* A plan with a July 1–June 30 plan year is determining highly compensated employees for its July 1, 2024–June 30, 2025, ADP testing. The plan makes a calendar year data election, and therefore, the look-back year for this purpose is January 1, 2024–December 31, 2024. The indexed compensation threshold for 2024 is $155,000 and for 2023 is $150,000. If an employee's compensation was more than $155,000 from January 1, 2024–December 31, 2024, the employee would be considered a highly compensated employee for the July 1, 2024–June 30, 2025, plan year for ADP testing purposes.

Only compensation received by the employee during the look-back year (or calendar year if using a calendar year data election) is considered in determining HCE status.[507] Compensation is not annualized.

Since highly compensated status depends on compensation for the "preceding year," it appears that no employee (other than a 5% owner) will be treated as highly compensated in his or her first plan year of employment. Moreover, an employee (other than a 5% owner) earning more than the highly compensated employee compensation threshold who is employed midyear may not be highly compensated until the third plan year in which he or she is employed. Query, however, whether an arrangement that is designed to take advantage of this rule, for example, by making a large contribution on behalf of a newly hired, highly paid employee would be considered discriminatory.[508]

For purposes of identifying highly compensated employees, compensation generally includes all compensation from the employer for the year which is includible in gross income — but is increased by the amount of any elective contributions under a cafeteria plan described in §125, a qualified transportation fringe under §132(f)(4), a §457(b) plan, a qualified CODA, a §401(k)-type simplified employee pension (SEP), a SIMPLE IRA, a §403(b) annuity contract, or mutual fund custodial account to the extent the employee could have elected to receive those contributions in cash.[509]

Practice Insight: This definition of compensation is not the same as the definition that applies for purposes of certain coverage and nondiscrimination rules, including the ADP and ACP tests.[510] The principal difference is that elective contributions under a cafeteria plan, a qualified CODA, a §403(b) annuity or mutual fund account, a SEP or SIMPLE IRA, or an eligible §457 plan must be included in compensation for purposes of identifying highly compensated employees.[511] However, for purposes of the nondiscrimination tests, the employer may elect whether to include certain such elective contributions in compensation.[512]

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[500] §416(i)(1)(B)(i)(I). *See* 554 T.M., *The Attribution Rules*, for a discussion of §318.

[501] Reg. §1.416-1, Q&A-T-18.

[502] §416(i)(1)(B)(iii)(I).

[503] §416(i)(1)(C).

[504] §414(q)(1)(B).

[505] Reg. §1.414(q)-1T, Q&A-3(c)(2).

[506] General Information Letter dated December 9, 1999, clarifying §1.414(q)-1T, Q&A-3(c)(2).

[507] Reg. §1.414(q)-1T, Q&A-13(c).

[508] Reg. §1.401(a)(4)-1(c)(2) (suggesting a spirit rule on top of the mechanical nondiscrimination rules).

[509] §414(q)(4), §415(c)(3); Reg. §1.414(q)-1T, Q&A-13.

[510] §401(k)(9), §401(m)(3)(B), §414(s); Reg. §1.414(s)-1(a)(2).

[511] §414(q)(4), §415(c)(3).

[512] §414(s)(2).

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3. *Identifying the Top-Paid Group for ADP and ACP Testing*

If the employer elects to limit its highly compensated employees to those included in the top-paid group (generally, the highest paid 20% of all employees),[513] the most complex part of determining HCEs is identifying such group. Note that all employees of the employer must be taken into account; the determination may not be made separately for each line of business.[514] Moreover, related employers must be aggregated and treated as one employer to the extent they are part of a controlled group or affiliated service group under §414(b), §414(c), §414(m), and §414(o).[515] Leased employees must also be taken into account as employees to the extent required by §414(n).[516]

Once the related employers have been aggregated and the total employees have been identified, the excluded employees must be identified. These include, generally:

(1) employees who have not completed six months of service;

(2) employees who normally work fewer than 17½ hours per week;

(3) employees who normally work during not more than six months of any year;

(4) employees who have not attained age 21; and

(5) certain nonresident aliens.[517]

The employer may elect to substitute smaller numbers of months or hours, or a lower age, for purposes of the first four categories above.[518] Any lower number or age must be applied uniformly in determining the highest paid 20% with respect to all of the employer's plans.[519] Other special rules apply in determining whether an employee normally works fewer than 17½ hours per week or in less than six months per year.[520]

Under temporary regulations, collectively bargained employees must generally be included in determining the top-paid group, but may be excluded if: (1) 90% or more of the employer's employees are covered by one or more collective bargaining agreements; and (2) the plan being tested covers only non-collectively bargained employees.[521]

The foregoing employees are excluded only "for purposes of determining the number of employees" in the highest paid 20%;[522] these employees themselves are not necessarily excluded from the highest paid 20%, or from the highly compensated employee group generally.[523] Certain nonresident aliens are excluded for all purposes in identifying highly compensated employees.[524]

Example: An employer has 100 employees, 20 of whom have not completed 180 days of service. None of the 100 employees falls within any other excluded category. Excluding the 20 employees who have not completed 180 days of service, 80 employees remain, and therefore the number of employees included in the top-paid group is 16. The top-paid group consists of the highest paid 16 among the total 100 employees, not the highest paid 16 of the non-excluded 80.[525]

Practice Insight: Looking at the top-paid group in the foregoing example (the highest paid 16 employees), only those receiving compensation above the HCE threshold are treated as highly compensated employees by reason of membership in the top-paid group. Those below the HCE compensation threshold are not considered highly compensated employees, despite being in the top-paid group. Nonetheless, it is possible one or more of these employees may be considered a highly compensated employee by virtue of being in the 5% owner category.

Practice Insight: In view of the complexity of determining the top-paid group, some employers will prefer to treat all employees earning over the HCE compensation threshold as highly compensated and will not elect the "top-paid group" restriction.

G. *Determining Compensation for the Plan Year for ADP and ACP Testing*

1. *Amounts Included in Compensation for ADP and ACP Testing*

A plan must determine the definition of compensation that will be used to calculate the actual deferral percentages and the actual contribution percentages for purposes of the ADP and ACP tests, respectively. For this purpose, a plan may select from a variety of definitions of compensation, described in more detail below.

In applying the ADP and ACP tests, the actual deferral percentages and actual contribution percentages must be computed using the definition of compensation in §414(s).[526] In addition, the amount of compensation that is taken into account for this purpose is limited to the §401(a)(17) limit (indexed annually)[527].

Practice Insight: A highly compensated employee earning in excess of the §401(a)(17) limit (described in II.A.2.b., above), will see an artificial increase in his or her actual deferral ratio by reducing the denominator (reduced to the amount allowed under §401(a)(17)). For example, an employee earning $385,000 and making an elective contribution of $15,400 in 2024, without the compensation limit set forth in §401(a)(17), would have an actual deferral ratio of 4% ($15,400/$385,000). Once the §401(a)(17) limit is in place, the actual deferral ratio increases to 4.46% ($15,400/$345,000). This could put added pressure on a plan's nondiscrimination test if the deferral ratios

[513] §414(q)(3); *see generally* Reg. §1.414(q)-1T, Q&A-9.
[514] §414(r)(1); 1986 TRA Conf. Rep. II-446.
[515] *See* §414(q)(7).
[516] *See* §414(q)(7).
[517] §414(q)(5).
[518] §414(q)(5) (flush language).
[519] 1986 TRA Conf. Rep., II-447; Reg. §1.414(q)-1T, Q&A-9; Reg. §1.414(q)-1, Q&A-9.
[520] Reg. §1.414(q)-1T, Q&A-9(e) and (f).
[521] Reg. §1.414(q)-1T, Q&A-9(b)(1)(iii).
[522] §414(q)(5).
[523] 1986 TRA Conf. Rep., II-444; Reg. §1.414(q)-1T, Q&A-9(c).
[524] §414(q)(8).
[525] 1986 TRA Conf. Rep. at II-444.
[526] §401(k)(9), §401(m)(3); Reg. §1.401(k)-6, §1.401(m)-5.
[527] §401(a)(17). For the dollar amounts for the current and previous years, see the Worksheets.

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of the non-highly compensated group do not stay within testing parameters.

Under §414(s), with certain limited exceptions, "compensation" has the same meaning as in §415(c)(3).[528] For self-employed individuals, compensation under §415(c)(3) is the employee's "earned income" within the meaning of §401(c)(2).[529]

Regulations under both §414(s) and §415(c)(3) provide that a plan may, as an alternative definition for employees other than self-employed individuals, define compensation to mean wages as reported on Form W-2, or wages subject to withholding under §3401(a), with certain modifications.[530] In addition to the available definitions under §415(c)(3), the regulations under §414(s) make available other alternatives.

For example, a plan may define compensation to ignore all reimbursements or other expense allowances, cash and non-cash fringe benefits, moving expenses, deferred compensation, and welfare benefits, even if includible in gross income.[531] The effect of using this alternative definition is to isolate wages, salary, overtime, and bonuses paid in cash, which may be easier for an employer to compute and administer for purposes of tracking the ADP and ACP tests.

Employers may also ignore items which apply only to highly compensated employees,[532] or may rely on any other "reasonable" definition of compensation so long as it meets other nondiscrimination tests set forth in the regulations.[533]

An employer may choose to define compensation as a gross amount, before salary reductions, or as a net amount, after salary reductions. This is due to the fact that whichever definition of compensation is used, §415(c)(3)(D) adds back elective contributions under §401(k), §403(b), or §408(k), any amounts electively deferred under §457, and any elective contributions under §125 or §132(f)(4).[534] However, §414(s)(2) allows an employer to elect not to include in compensation the same types of elective deferrals or contributions.

Practice Insight: In some cases, using the broadest possible definition of compensation will help highly compensated employees maximize contributions under the CODA or §401(m) plan. This happens because the higher compensation amount will increase the compensation figure used in the denominators of the actual deferral ratio and actual contribution ratio, thus reducing the highly compensated employees' percentage(s).

> *Example:* Assume a highly compensated employee earns \$100,000 and wants to defer \$9,000 under a CODA. If the plan defines compensation using the §415(c)(3) definition of compensation, the employee's deferral percentage is 9.89% (\$9,000/\$91,000). If the plan defines compensation under Reg. §1.414(s)-1(c)(4), the \$9,000 deferral is added back into the definition of compensation and thus the employee's percentage drops almost a full percentage point to 9% (\$9,000/\$100,000). The lower ADP rate could help manage the HCE contribution rate when compared to the non-HCE rate of contribution. To the extent that non-highly compensated employees contribute, on average, at a lesser rate, adding their CODA contribution back into compensation will have less of an impact on their deferral percentages because the dollars deferred are much smaller, thus bringing the averages for the highly compensated closer to the averages for the non-highly compensated. In other situations, where non-highly compensated employees earn substantial overtime pay, a broad definition will adversely affect the ADP test.
>
> An employer may elect different definitions of compensation under §414(s) for different purposes, as long as the definition for a particular purpose applies uniformly for that purpose.[535] For example, an employer may have reason to use one definition for purposes of applying the ADP test and a separate definition for purposes of applying the §401(a)(4) nondiscrimination rules to a profit-sharing contribution. However, the definition used for ADP or ACP test purposes must be used uniformly when determining the deferral or contribution percentages for all eligible employees. In addition, an employer may change its definition of compensation for a particular application, including the ADP and ACP tests from one year to the next.[536]

2. Period in Which Compensation Is Measured for ADP and ACP Testing

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.[537] Whichever period is selected must be applied uniformly to determine the compensation of every eligible employee under the plan for the particular plan year for purposes of the ADP or ACP test.[538] It appears that this selection is made operationally, and need not be predetermined under the plan document.

An employer may also limit the period taken into account to that portion of the plan year (or calendar year ending within the plan year, if selected) in which the employee was an eligible employee, so long as this approach, too, is applied uniformly to all eligible employees under the plan for the particular plan year.[539]

Practice Insight: The ability to limit compensation to only a portion of a year is likely to be most helpful to small or mid-sized plans, where the deferral and contribution percentages of just a few individuals have relatively more weight. Ignoring an employee's compensation for a portion of a year during which he or she was ineligible for the plan will raise his or her actual deferral ratio and actual contribution ratio by reducing the denominator. Accordingly, in practice, since non-5% owners are not highly compensated employees in their first year of employment, limiting the compensation taken into account will generally help a plan satisfy the ADP and ACP tests.

[528] §414(s)(1); Reg. §1.414(s)-1. *See* the Worksheets.
[529] Reg. §1.415(c)-2(b)(2).
[530] Reg. §1.414(s)-1(c)(2), §1.415(d)-2(d).
[531] Reg. §1.414(s)-1(c)(3).
[532] Reg. §1.414(s)-1(c)(5).
[533] *See* Reg. §1.414(s)-1(d) and §1.414(s)-1(e).
[534] §415(c)(3)(D).
[535] Reg. §1.414(s)-1(b)(2).
[536] Reg. §1.414(s)-1(b)(2).
[537] Reg. §1.401(k)-6, §1.401(m)-5.
[538] Reg. §1.401(k)-6, §1.401(m)-5.
[539] Reg. §1.401(k)-6, §1.401(m)-5.

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H. Contributions Taken into Account for ADP Testing

An employee's actual deferral ratio under the ADP test is generally calculated by dividing the employee's elective contributions (including Roth and any PLESA contributions) by the employee's compensation for the year. See III.G., above, for a discussion of how to calculate compensation for these purposes. See I.D.1., above, for a definition of elective contributions. In certain circumstances, discussed below, qualified nonelective contributions and qualified matching contributions may be added to the employee's elective deferrals when making this calculation.

An elective contribution is taken into account in determining an employee's actual deferral ratio for a plan year only if the contribution is "allocated to the employee's account" as of a date during the plan year, and it relates to compensation that either would have been received in the plan year, or is attributable to services performed during the plan year and would have been received by the employee within 2½ months after the close of the plan year.[540] For purposes of this rule, an elective contribution is treated as "allocated" as of a date during the plan year only if the allocation is not contingent upon continued participation in the plan after the date of allocation, or the performance of services after the date of allocation, and the elective contribution is paid to the trust no later than the end of the 12-month period immediately following the plan year to which the contribution related.[541]

Practice Insight: Although the regulations under §401(k) would theoretically permit an employer to delay depositing its elective contributions for a period of up to 12 months after the plan year, the "plan asset regulations" issued by the Department of Labor under Title I of ERISA effectively require an employer to contribute the elective contributions as soon as the amounts can be reasonably segregated from general assets, but no later than 15 business days after the end of the month in which the compensation to which the deferrals relate would have been paid.[542] Regulations provide an optional safe harbor for plans that have fewer than 100 participants at the beginning of the plan year.[543]

In the case of an elective contribution for partners, a partner's distributive share of partnership income is treated as received on the last day of the partnership tax year. Similarly, a sole proprietor's compensation is treated as received on the last day of the individual's tax year. Thus, an elective contribution made on behalf of a partner or sole proprietor is treated as allocated to the partner's or sole proprietor's account for the plan year that includes the last day of the partnership tax year or the sole proprietor's tax year if the other requirements for taking elective deferrals into account (set forth in the prior paragraph) are met.[544]

[540] Reg. §1.401(k)-2(a)(4)(i). *See* PLR 199924067 (amounts deferred under irrevocable election made before the end of the year preceding the year of the deferrals and initially held in a nonqualified plan before being transferred to a qualified plan will be treated as made to the qualified plan in the year in which the compensation to which the deferrals relate was earned for purposes of the ADP test).

[541] Reg. §1.401(k)-2(a)(4)(i)(A).

[542] 29 C.F.R. §2510.3-102(b).

[543] 29 C.F.R. §2510.3-102(a)(2) and §2510.3-102(f), 75 Fed. Reg. 2068 (Jan. 14, 2010).

If any elective contributions are made for a plan year but do not meet the allocation and contribution deadlines set forth above, they may not be taken into account under the ADP test, but are instead subject to the general nondiscrimination test under §401(a)(4) as if they were nonelective employer contributions, and the only nonelective employer contributions, made for the plan year.[545] This approach would apply, for example, for bonus deferrals where the bonuses were paid on account of a plan year but later than 2½ months after the end of the plan year.

Excess deferrals under §402(g) are counted under the ADP test, with the exception of excess deferrals of non-highly compensated employees that are determined by the employer to be excess deferrals without taking into account any deferrals through other employers.[546] See VII.E., below, for a discussion of excess deferrals.

1. Catch-Up and Other Elective Contributions Not Taken into Account for ADP Testing

Certain categories of elective contributions are not taken into account when determining an employee's actual deferral ratio.

The most significant of these categories is elective contributions that are treated as catch-up contributions under §414(v).[547] Catch-up contributions are subtracted from an employee's elective contributions for the plan year in determining the employee's actual deferral ratio.[548]

> *Example:* Employee B is a catch-up eligible participant with compensation of $155,000. The plan does not limit elective contributions except to comply with §415 and §402(g), and permits §414(v) catch-up contributions. In 2025, the §402(g) limit is $23,500 and the §414(v) limit is $7,500. Employee B makes elective contributions of $31,000. Employee B's actual deferral ratio is 15.2% ($23,500/$155,000), not 20% ($31,000/$155,000).[549]

Other categories of elective contributions that are not taken into account include contributions made pursuant to §414(u) by reason of qualified military service and contributions that are withdrawn under §414(w) by reason of a permissible withdrawal of automatic deferrals.[550] Despite its name, the Saver's Match, a government funded matching contribution which may be accepted by certain qualified plans beginning on January 1, 2027, is treated as an elective deferral, but is disregarded for purposes of ADP testing.[551]

[544] Reg. §1.401(k)-2(a)(4)(ii).

[545] Reg. §1.401(k)-2(a)(5). The general nondiscrimination test under §401(a)(4) is described in 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans.*

[546] §402(g)(2)(B); Reg. §1.402(g)-1(e)(1)(ii).

[547] Reg. §1.401(k)-2(a)(5)(iii).

[548] Reg. §1.414(v)-1(d)(2)(i).

[549] Notice 2024-80. For recent inflation-adjusted limits, see Worksheet 1 of 371 T.M., *Employee Plans — Deductions, Contributions, and Funding.*

[550] Reg. §1.401(k)-2(a)(5).

[551] §6433(f)(2)(A)(1), §6433(f)(2)(B), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §103(a), effective for tax years beginning after December 31, 2026.

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2. *Counting Qualified Nonelective Contributions and Qualified Matching Contributions for Purposes of ADP Testing*

For purposes of determining an employee's actual deferral ratio, regulations allow an employer to take any "qualified nonelective contribution" and "qualified matching contribution" made on behalf of the employee, subject to certain conditions, into account for purposes of calculating an employee's actual deferral ratio.[552]

Note: Also see III.L.1., below, for a discussion of using QNECs and QMACs as measures to ensure compliance with the ADP test.

In general, a "matching contribution" is any employer contribution made to a defined contribution plan, or forfeiture that is allocated to an account, based on either an elective contribution or an employee after-tax contribution.[553] A "qualified matching contribution" (often called a QMAC) is a matching contribution that is nonforfeitable and satisfies the distribution restrictions applicable to elective contributions under §401(k)(2)(B)(1) (i.e., generally, a distribution may not be made before severance from employment, death, disability, age 59½, hardship, or plan termination).[554] The contributions must be nonforfeitable and subject to the elective contribution distribution restrictions when allocated to participants' accounts.[555]

Practice Insight: For plan years ending before July 20, 2018, a plan could not use forfeitures to fund QMACs and QNECs because they were forfeitable when first contributed to the plan. However, for plan years ending on or after July 20, 2018, the definitions of QMAC and QNEC were revised to clarify that they must be nonforfeitable and subject to elective contribution distribution restrictions when they are allocated to participants' accounts rather than when they are first contributed to the plan. This allows for the use of plan forfeitures to fund QMACs and QNECs.[556] However, if a plan requires a specific allocation to participant accounts, possibly after the payment of plan expenses, a plan amendment will be needed to redefine how forfeitures may be used.

A matching contribution may be treated as "nonforfeitable" and therefore "qualified," even if, under the terms of the plan, it is forfeited because the contribution to which it relates is treated as an excess deferral under §402(g), excess contribution due to an ADP test failure, or excess aggregate contribution due to an ACP test failure.[557]

Example: A profit-sharing plan provides that for each dollar of elective contributions made for an employee pursuant to a CODA, the employer will contribute an additional $0.50 to the employee's account. Many employers limit the matching contribution by matching elective contributions only up to the first 6% (or other specified percentage) of pay. If the matching contributions are fully vested and subject to the distribution restrictions applicable to elective contributions, they are "qualified matching contributions."

A qualified nonelective contribution (often called a QNEC) is defined as any employer contribution (other than a matching contribution) which is not subject to a cash or deferred election.[558] Like qualified matching contributions, QNECs must be nonforfeitable (i.e., fully vested) and subject to the distribution restrictions applicable to elective contributions when allocated to participants' accounts.[559]

Example: In addition to elective contributions, an employer contributes an amount equal to 5% of compensation for each eligible employee, whether or not the employee makes elective contributions. If the 5% contributions are fully vested and subject to the distribution restrictions applicable to elective contributions, the 5% contributions are qualified nonelective contributions.

An employer may elect to treat all or any part of the QMACs and QNECs made on behalf of any or all eligible employees as elective contributions, provided certain rules are met.[560] In order to be taken into account as an elective contribution for this purpose, both QMACs and QNECs must meet the allocation timing rules for elective contributions described above in III.H. (i.e., must be allocated to the employee's account as of a date within the plan year and paid to the trust within the 12-month period following the plan year).[561] QMACs must also meet the nondiscrimination requirements applicable to matching contributions generally under §401(m). QNECs may be counted as elective contributions if both the entire amount of nonelective contributions and the amount which is not being used toward the actual deferral percentage satisfy the nondiscrimination requirements of §401(a)(4), and if the nonelective contributions are either made under the same plan as the elective contributions or made under a plan that could be aggregated with the plan containing the CODA under §410(b).[562] Special rules apply if the nonelective contributions are made under a separate plan and the CODA plan year is changed in order to allow aggregation under §410(b).[563]

Example: Five eligible employees participate in a plan which offers a salary reduction CODA and provides for discretionary employer contributions that meet the defin-

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552 Reg. §1.401(k)-2(a)(6).

553 §401(m)(4); Reg. §1.401(m)-1(a)(2). See I.D.2., above, for a detailed definition of matching contributions.

554 Reg. §1.401(k)-6.

555 Reg. §1.401(k)-6, as amended by T.D. 9835, 83 Fed. Reg. 34,469 (July 20, 2018), applicable to plan years ending on or after July 20, 2018.

556 *See* Reg. §1.401(k)-6 and §1.401(m)-5, as amended by T.D. 9835, 83 Fed. Reg. 34,469 (July 20, 2018).

557 Reg. §1.401(k)-6, referencing Reg. §1.401(k)-2(b)(4)(iii).

558 §401(m)(4)(C); Reg. §1.401(k)-6.

559 Reg. §1.401(k)-6.

560 Reg. §1.401(k)-2(a)(6).

561 Reg. §1.401(k)-2(a)(6)(ii).

562 Reg. §1.401(k)-2(a)(6)(iii). See 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*, for a discussion of the §401(a)(4) nondiscrimination test. See III.C., above, for a discussion of the aggregation rules.

563 Reg. §1.401(k)-2(a)(6)(iii).

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ition of qualified nonelective contributions. Employees 1 and 2 are highly compensated employees. The employer elects to compute the actual deferral percentage for the non-highly compensated employees for the current year and not the prior year. For the 2010 plan year, the following contributions were made:

Employee	Compensation	Elective Contributions	Qualified Nonelective Contributions	ADP w/o QNEC	ADP with QNEC
1	$125,000	$11,250	$5,000	9%	13%
2	$120,000	$13,200	$4,800	11%	15%
3	$60,000	$9,000	$3,000	15%	20%
4	$30,000	$0	$1,500	0%	5%
5	$30,000	$2,000	$1,500	6.67%	11.67%

The plan will fail the 1.25 and 2.0 tests if the actual deferral percentages are computed by ignoring the QNECs, because the ADP for highly compensated employees (10.00%) is more than 1.25 times the ADP for non-highly compensated employees (7.22%), and the difference is greater than 2.0%. However, the plan will pass the 1.25 test if the QNECs are taken into account, as these contributions help raise everyone's percentage, and thus the averages, into a closer range (14.00% for highly compensated employees, 12.22% for non-highly compensated employees).

Practice Insight: Although it might be tempting to use only the QNECs made on behalf of non-highly compensated employees to satisfy the ADP test (and, therefore keep the ADP for highly compensated employees lower), the regulations effectively preclude this by requiring that the QNECs that are not used to compute the actual deferral percentagest, standing by themselves, satisfy the general nondiscrimination rules of §401(a)(4).[564] Thus, if the QNECs of only the non-highly compensated employees were used to satisfy the ADP test, the remaining nonelective contributions (if any) made on behalf of the highly compensated employees would likely fail §401(a)(4) nondiscrimination requirements.

The regulations also place limits on the extent to which targeted QNECs, i.e., QNECs made on behalf of particular non-highly compensated employees, may be taken into account.[565] These are sometimes referred to as "bottom-up" QNECs because employers would make a QNEC to the non-highly compensated employee with the lowest compensation during the year in order to raise the employee's actual deferral ratio. If the plan still did not satisfy the ADP test, the employer would continue to expand the group of non-highly compensated employees who receive the QNECs to the next lowest paid employee until the ADP test is satisfied. This methodology allowed a plan to satisfy the ADP test at modest cost because the QNEC was made for the benefit of the lowest paid employees but the impact on the ADP test was material when expressed as a percentage of the employee's compensation.

To avoid this perceived abuse, the regulations provide that a plan may count a QNEC for a non-highly compensated employee that is greater than 5% of the employee's compensation only if the QNEC does not exceed two times the plan's "representative contribution rate."[566] The representative contribution rate is based on the "applicable contribution rate" of a certain non-HCE.[567] The applicable contribution rate for a non-HCE is calculated by taking the QMACs that are considered elective contributions for the year, plus any QNECs, divided by the non-HCEs compensation for the year.[568] The representative contribution rate is then determined to be the greater of: (i) the lowest applicable contribution rate of a non-HCE among a group of non-HCEs that consists of at least half of the non-HCEs; or (ii) the lowest applicable contribution rate of any non-HCE in a group of all non-HCEs who are employed as of the last day of the plan year.[569] A similar limitation applies to QNECs taken into account under the ACP test.[570]

Practice Insight: This complicated provision is intended to prevent employers from providing much larger QNECs to the very lowest paid employees, in order to satisfy the ADP test.

A special rule, however, increases the 5% threshold to 10% for QNECs made in connection with an employer's obligation to pay a prevailing wage under the Davis-Bacon Act.[571]

The election to count all or part of QMACs or QNECs as elective contributions can be made under either the current year method or the prior year method and may vary from year to year; there is no requirement in the regulations that the election be made in writing or in connection with any filing. (See III.D., above, for discussion regarding current- and prior-year testing methods). However, in order to be taken into account for a year under the prior-year method, a QNEC or QMAC must be allocated as of a date within the year and must actually be paid to

[564] Reg. §1.401(k)-2(a)(6)(ii).
[565] Reg. §1.401(k)-2(a)(6)(iv).
[566] Reg. §1.401(k)-2(a)(6)(iv)(A).
[567] Reg. §1.401(k)-2(a)(6)(iv)(C).
[568] Reg. §1.401(k)-2(a)(6)(iv)(C).
[569] Reg. §1.401(k)-2(a)(6)(iv)(B).
[570] Reg. §1.401(m)-2(a)(6)(v)(A).
[571] Reg. §1.401(k)-2(a)(6)(iv)(D).

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the trust no later than the end of the 12-month period following the end of the year for which the contribution is taken into account.[572] Consequently, under the prior year testing method, in order to be taken into account in calculating the ADP or ACP for non-highly compensated employees for the prior year, a QNEC or QMAC must be contributed by the end of the testing year.

> *Example:* If the prior-year testing method is used for the 2024 testing year, QNECs that are allocated to the accounts of non-highly compensated employees for the 2023 plan year (i.e., the prior year) must be contributed to the plan by the end of the 2024 plan year in order to be treated as elective contributions for purposes of the ADP test for the 2024 testing year. By contrast, in order to be taken into account in calculating the ADP for highly compensated employees for the 2024 testing year, a QNEC or QMAC must be contributed by the end of the 2025 plan year.[573]

Practice Insight: A plan may violate limitation requirements under §415 even if the employer makes the QNEC or QMAC contribution within the time period described above (i.e., before the end of the 12-month period following the end of the year for which the contribution is taken into account). See II.A.2.a., above, for a discussion of the §415 requirements. For purposes of satisfying §415, employer contributions shall not be deemed credited to a participant's account for a particular limitation year unless the contributions are actually made to the plan no later than 30 days after the end of the period described in §404(a)(6) applicable to the tax year with or within which the particular limitation year ends.[574] Thus, contributions made after this date are treated as annual additions for the next §415 limitation year. Accordingly, under either the prior year testing method or the current year testing method, a violation of §415(c) might occur if QNECs or QMACs are contributed after the date described in Reg. §1.415(c)-1(b)(6)(i)(B), but before the end of the 12-month period following the end of the year for which the contribution is taken into account.[575]

As mentioned above, a plan must satisfy the nondiscrimination requirements of §401(a)(4) with respect to the amount of nonelective contributions, both including and excluding the QNECs treated as elective contributions.[576] These rules raise particular issues if prior year testing is used since the QNECs used as elective contributions for highly compensated employees and non-highly compensated employees relate to different ADP testing years. If, for example, a QNEC is made for a prior year to improve the ADP test results for the current year, only the QNECs for non-highly compensated employees would be treated as elective contributions for the prior year. When those QNECs are excluded in testing for §401(a)(4) compliance for the prior year, the highly compensated employees may have received disproportionate nonelective contributions.

QNECs and QMACs cannot be taken into account in performing the ADP test for a plan to the extent such contributions are taken into account for purposes of satisfying any other ADP test, any ACP test, or any safe harbor contribution requirement.[577] Thus, for example, a QNEC cannot be taken into account under both the ADP and ACP tests, effectively prohibiting double counting.

3. *Contribution Consideration for Plans That Change from the Current Year to the Prior Year Testing Method*

If a plan changes from the current year testing method to the prior year method, QNECs that were taken into account for the current year testing method for a year may not be taken into account under the prior year testing method the next year.[578] Under these rules, the ADP for non-highly compensated employees for the prior year is determined taking into account only: (1) elective contributions for those non-highly compensated employees that were taken into account for purposes of the ADP test (and not the ACP test) under the current year testing method for the prior year; and (2) QNECs that were allocated to the accounts of those non-highly compensated employees for the prior year but that were not used to satisfy the ADP test or the ACP test under the current year testing method for the prior year.

The ACP for non-highly compensated employees for the prior year is determined taking into account only: (1) employee after-tax contributions for those non-highly compensated employees for the prior year; (2) matching contributions for those non-highly compensated employees that were taken into account for purposes of the ACP test (and not the ADP test) under the current year testing method for the prior year; and (3) QNECs that were allocated to the accounts of those non-highly compensated employees for the prior year but that were not used to satisfy the ACP test or the ADP test under the current year testing method for the prior year.[579]

Thus, in determining the ADP for non-highly compensated employees for the prior year, the following contributions made for the prior testing year are disregarded: QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year, elective contributions taken into account for purposes of the ACP test, and all QMACs. Similarly, in determining the ACP for non-highly compensated employees for the prior year, the following contributions made for the prior testing year are disregarded: QNECs used to satisfy either the ADP or ACP test under the current year testing method for the prior testing year, QMACs taken into account for purposes of the ADP test, and all elective contributions.

> *Example:* Assume Employer B established Plan M, a calendar year §401(k) plan, in 2014 and, through the 2024 testing year, has always used the current year testing method under Plan M. The ADP for the highly compensated employees under Plan M is 7% for the 2024 testing year. Based solely on elective contributions by non-highly compensated employees under Plan M for the 2024 testing

[572] Reg. §1.401(k)-2(a)(6)(i), §1.401(m)-2(a)(6)(i).
[573] Notice 98-1.
[574] Reg. §1.415(c)-1(b)(6)(i)(B).
[575] Notice 98-1, §IV.A.
[576] Reg. §1.401(k)-2(a)(6)(ii); *see also* Notice 98-1.
[577] Reg. §1.401(k)-2(a)(6)(vi), §1.401(m)-2(a)(5)(iii).
[578] Reg. §1.401(k)-2(a)(6)(vi). The limitations on double counting did not apply for testing years beginning before January 1, 1999. *See* Notice 98-1.
[579] Reg. §1.401(m)-2(a)(6)(vi).

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year, the ADP for non-highly compensated employees for the 2024 testing year is 4%. In order to satisfy the ADP test, Employer B provides a QNEC to each non-highly compensated employee for the 2024 testing year equal to 1% of compensation. No other contributions under Plan M are taken into account in determining the ADP for non-highly compensated employees. Thus, the ADP for non-highly compensated employees for the 2024 testing year is 5%. Plan M is amended to use the prior year testing method instead of the current year testing method for purposes of the ADP test for the 2025 testing year.

In determining the ADP for non-highly compensated employees under Plan M for the 2025 testing year in accordance with the prior year testing method, the elective contributions made by non-highly compensated employees under Plan M for the 2024 plan year are taken into account. However, the QNECs equal to 1% of compensation made under Plan M on behalf of non-highly compensated employees for the 2024 plan year are disregarded because they were used to satisfy the ADP test for the 2024 testing year. Thus, for purposes of the 2025 testing year, the ADP for non-highly compensated employees for the prior year is 4% (unless additional QNECs for non-highly compensated employees are timely contributed and allocated for the 2024 plan year).

I. Contributions Taken into Account for ACP Testing

Employee after-tax contributions and matching contributions are taken into account for purposes of calculating the actual contribution percentage under the ACP test. In certain circumstances, discussed below, elective contributions and qualified nonelective contributions may be added to the employee after-tax contributions and matching contributions when making this calculation. See I.D., above, for definitions of the contribution types.

Employee after-tax contributions are taken into account for ACP test purposes for the plan year in which the contribution is made — which generally means the year in which the amount is withheld from pay, so long as they are transmitted within a reasonable period after the withholding.[580] If the plan failed the ADP test, excess contributions may be recharacterized as employee after-tax contributions.[581] Excess contributions under the ADP test recharacterized as after-tax contributions are taken into account for the plan year in which the excess contributions would be included in gross income if distributed, i.e., in the year the elective contributions were made, if they are recharacterized within 2½ months after the end of the plan year, and if they exceed the $100 de minimis threshold; otherwise they are taken into account in the following plan year.[582]

A matching contribution is taken into account for a plan year only if it is allocated to the employee's account under the terms of the plan as of a date within that year, is made or allocated on account of the employee's elected contributions or employee after-tax contributions for that year, and is actually paid to the trust no later than 12 months following the end of the year.[583] Matching contributions that are made in a year, but cannot be taken into account because they do not satisfy these conditions, may not be taken into account in the ACP test for any other plan year, but instead must satisfy the §401(a)(4) nondiscrimination requirements for the plan year in which they are allocated under the plan as if they were the only nonelective contributions for that year.[584] The §401(a)(4) nondiscrimination requirements are discussed in 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans.*

1. Matching and Employee After-Tax Contributions Not Taken into Account for ACP Testing

A number of additional rules apply under which matching contributions and employee after-tax contributions are not taken into account for the ACP test:

(1) Certain disproportionate matching contributions are not taken into account. Specifically, matching contributions are not taken into account for non-highly compensated employees to the extent they exceed the greatest of: (i) 5% of compensation; (ii) the employees' elective contributions for the year; and (iii) twice the plan's "representative matching rate."[585] The plan's "representative matching rate" is the lowest matching rate for any eligible non-highly compensated employee among a group that consists of half of all eligible non-highly compensated employees who make elective contributions for the plan year.[586] (However, the representative matching rate is not less than the lowest matching rate for all eligible non-highly compensated employees in the plan who are employed by the employer on the last day of the plan year and who make elective contributions for the year.) The matching rate is generally the matching contributions made for the employee divided by the elective contributions for the year.[587]

Practice Insight: This complicated provision is intended to prevent employers from providing much larger matching contributions to the very lowest paid employees, in order to satisfy the ACP test. However, it is somewhat broader than necessary to address the perceived abuse. The provision means that matching contributions in excess of 100% of any employee's elective contributions are disregarded under the ACP test. This creates challenges for a plan that provides for matching contributions in excess of 100% of an employee's elective contributions, sometimes referred to as "super matches," even if the super match is generally available.

(2) Qualified matching contributions used to satisfy the ADP test are not taken into account for the ACP test.[588]

580 Reg. §1.401(m)-2(a)(4)(i).

581 See III.M.5., below, for a description of recharacterizing excess contributions as employee after-tax contributions.

582 Reg. §1.401(m)-2(a)(4)(ii); *see* Reg. §1.401(k)-2(b)(2)(vi) and §1.401(k)-2(b)(3).

583 Reg. §1.401(m)-2(a)(4)(iii).

584 Reg. §1.401(m)-2(a)(5).

585 Reg. §1.401(m)-2(a)(5)(ii)(A). Note if the plan provides a match based on an employee's after-tax contributions, such contributions will be taken into consideration as specified under Reg. §1.401(m)-2(a)(5)(ii)(D).

586 Reg. §1.401(m)-2(a)(5)(ii)(B).

587 Reg. §1.401(m)-2(a)(5)(ii)(C).

588 Reg. §1.401(m)-2(a)(5)(iii); *see* Reg. §1.401(k)-2(a)(6).

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(3) Certain matching contributions that are taken into account under safe harbor provisions are not taken into account. Specifically, where a plan satisfies the safe harbor requirements of §401(m)(11) or §401(m)(12) but nonetheless must apply the ACP test to employee after-tax contributions, it is permitted to disregard matching contributions in applying that test. In addition, if the plan satisfies the ADP safe harbor requirements under §1.401(k)-3, but does not satisfy the ACP safe harbor requirements, the plan may disregard all matching contributions that do not exceed 4% of an employee's compensation (or 3.5% if a plan satisfies the ADP safe harbor under §401(k)(13)).[589] See IV., for a discussion of safe harbor requirements.

(4) A matching contribution is not taken into account if it is forfeited because it relates to an excess contribution under §401(k), excess deferral under §402(g) or excess aggregate contribution under §401(m).[590]

(5) Employee after-tax contributions and matching contributions made by reason of qualified military service under §414(u) are not taken into account.[591]

2. *Counting Elective Contributions and Qualified Nonelective Contributions for ACP Testing*

Elective contributions and QNECs[592] can be taken into account in applying the ACP test if several conditions are satisfied:[593]

(1) The contributions are allocated to the employee's account as of a date within the year, meaning that they are not contingent upon participation in the plan or performance of services on any subsequent date, and are actually paid to the trust no later than 12 months after the end of the year to which the contribution relates.[594]

(2) Elective contributions can be taken into account for the ACP test only if the ADP test is met including the elective contributions (as opposed to relying on the design-based safe harbor of §1.401(k)-3), as well as excluding the elective contributions.[595]

(3) Elective contributions that cannot be taken into account for purposes of the ADP test cannot be taken into account for purposes of the ACP test.[596] This includes elective contributions treated as catch-up contributions and elective deferrals that exceed the limitations of §402(g).

(4) The qualified nonelective contributions, including and excluding those contributions taken into account for the ADP or ACP test, or both, must satisfy §401(a)(4) nondiscrimination requirements.[597] See 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*, for a discussion of the §401(a)(4) nondiscrimination requirements.

(5) The plan providing for the qualified nonelective contributions or elective contributions must be permitted to be aggregated with the plan for which the ACP test is being performed.[598] See III.C.2., above, for a discussion of the permitted aggregation rules.

(6) Disproportionate QNECs cannot be taken into account for a non-highly compensated employee to the extent the contributions exceed the greater of 5% of compensation or twice the plan's representative contribution rate. "Representative contribution rate" is defined in a manner similar to "representative matching rate," discussed earlier in this section. See III.H.2., above, for a discussion of the representative contribution rate. The 5% contribution rate increases to 10% for qualified nonelective contributions made in connection with obligations under the Davis-Bacon Act.[599]

(7) QNECs cannot be taken into account for ACP testing if they are taken into account for purposes of satisfying an ADP test, another ACP test, or the safe harbor design requirements of Reg. §1.401(k)-3, §1.401(m)-3, or §1.401(k)-4.[600] This means, for example, that QNECs taken into account for current year ACP testing may not be taken into account in the following year for prior year ACP testing.

Example: An employer maintains a qualified profit-sharing plan containing a CODA. Employees may make elective contributions under the CODA, and the employer will make a matching contribution equal to 50% of the elective contributions which do not exceed 6% of the participant's compensation. In addition, the employer makes annual, nonelective profit-sharing contributions based upon the employer's profits for the year. All employer contributions under the plan are fully and immediately vested, and are subject to the elective contributions distribution restrictions (e.g., distribution may not be made before age 59½ in circumstances other than death, disability, or severance from employment). The employer elects to compute the actual contribution percentage for the non-highly compensated employees for the current year and not the prior year. For Plan Year 1, the following contributions are made under the plan, expressed as a percentage of compensation:

Eligible Employee	Elective Contributions	Matching Contributions	Qualified Nonelective Contributions
1 (HCE)	6%	3%	1%
2 (HCE)	0%	0%	1%
3 (Non-HCE)	4%	2%	1%

[589] Reg. §1.401(m)-2(a)(5)(iv).
[590] Reg. §1.401(m)-2(a)(5)(v).
[591] Reg. §1.401(m)-2(a)(5)(vi).
[592] See I.D.5., above, for a definition of QNECs.
[593] Reg. §1.401(m)-2(a)(6).
[594] Reg. §1.401(m)-2(a)(6)(i).
[595] Reg. §1.401(m)-2(a)(6)(ii); *see* Reg. §1.401(m)-2(a)(7) *Ex.* 3.
[596] Reg. §1.401(m)-2(a)(6)(ii).
[597] Reg. §1.401(m)-2(a)(6)(iii).
[598] Reg. §1.401(m)-2(a)(6)(iv).
[599] Reg. §1.401(m)-2(a)(6)(v).
[600] Reg. §1.401(m)-2(a)(6)(vi).

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4 (Non-HCE)	0%	0%	1%
5 (Non-HCE)	0%	0%	1%
6 (Non-HCE)	0%	0%	1%

Employees 1 and 2 are highly compensated employees, and the others are not. The elective contributions, standing alone, will fail to satisfy the ADP test (1.25 or 2.0 tests). The actual deferral percentage for the highly compensated employees will be 3% (6% + 0% = 6%/2 = 3%), while the actual deferral percentage for the non-highly compensated employees will be only 1% (4% + 0% + 0% + 0% = 4%/4 = 1%). If the nonelective contributions are combined with the elective contributions, however, the ADP 2.0 test will be satisfied. The actual deferral percentage for the highly compensated employees will be 4% (7% + 1% = 8%/2 = 4%), and the actual deferral percentage for the non-highly compensated employees will be 2% (5% + 1% + 1% + 1% = 8%/4 = 2%).

The matching contributions will satisfy neither ACP test (1.25 test nor the 2.0 test). The contribution percentage for the highly compensated employees will be 1.5% (3% + 0% = 3%/2 = 1.5%), and the contribution percentage for the non-highly compensated employees will be 0.5% (2% + 0% + 0% + 0% = 2%/4 = 0.5%). The nonelective contributions may not be combined with the matching contributions to help them satisfy the ACP test because the nonelective contributions are already needed to help satisfy the ADP test.

If the nonelective contributions in the foregoing example were 5% of compensation instead of 1% for each eligible employee, the nonelective contributions could be divided into two parts, a 1% contribution that would permit the elective contributions to satisfy the APD 2.0 test, and a 4% contribution that would permit the matching contributions to satisfy the ACP 1.25 test.

Practice Insight: Where QNECs are sufficient either to help elective contributions satisfy the ADP test or to help matching contributions satisfy the ACP test but not both, there appears to be no constraint on the administrator's ability to choose whether to apply such nonelective contributions toward the ADP test or the ACP test.

Note: If matching contributions are forfeited as excess aggregate contributions (i.e., to correct an ACP test failure, as discussed in III.M.7., below), any highly compensated employees who are not vested will prefer to have QNECs applied first to help satisfy the ACP test before they are applied to the ADP test because a return of excess elective contributions is not as unattractive as a forfeiture of matching contributions, although any matching contributions attributable to the excess elective contributions would be forfeited.

See also III.L.1., below, for a discussion of using nonelective employer contributions to satisfy the ACP test.

J. Illustrations of the ADP and ACP Tests

1. The 1.25 Test

The 1.25 test is satisfied if the actual deferral percentage or the actual contribution percentage, as applicable, for the highly compensated employees is not more than the actual deferral percentage for the non-highly compensated employees multiplied by 1.25.[601]

Example 1: An employer maintains a profit-sharing plan consisting solely of a CODA, under which employees may make elective contributions pursuant to salary reduction agreements, up to a maximum of 15% of compensation. The plan defines compensation for testing purposes as gross pay before any salary reductions. For the 12-month plan year ending December 31, 2024, the employer elects to compute the actual deferral percentage for the non-highly compensated employees for the current year and not the prior year. The seven eligible employees make the following elections:

[601] §401(k)(3)(A)(ii)(I).

Eligible Employee	Compensation Before Plan Contribution	Elective Contribution	Actual Deferral Ratio
1	$120,000	$12,000	10% ($12,000/$120,000)
2	$110,000	$11,000	10% ($11,000/$110,000)
3	$30,000	$4,500	15% ($4,500/$30,000)
4	$25,000	$2,500	10% ($2,500/$25,000)
5	$20,000	$0	0% ($0/$20,000)
6	$15,000	$0	0% ($0/$15,000)
7	$12,000	$1,800	15% ($1,800/$12,000)

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Employees 1 and 2 are highly compensated employees under §414(q). Their actual deferral percentage is 10% (10% + 10% = 20%/2 = 10%). The actual deferral percentage for the non-highly compensated employees is 8% (15% + 10% + 0% + 0% + 15% = 40%/5 = 8%). Under this example, the 1.25 test is satisfied because the actual deferral percentage for the highly compensated employees (10%) does not exceed 1.25 multiplied by the actual deferral percentage for the non-highly compensated employees (8%).

Example 2: A plan provides for matching contributions equal to 50% of all elective contributions, and does not provide for any after-tax employee contributions. Also, the employer elects to compute the actual contribution percentage for the non-highly compensated employees for the current year and not the prior year. For the current plan year, the elective contributions and matching contributions represent the following percentages of compensation for each eligible employee:

Eligible Employee	Elective Contribution as a Percentage of Compensation	Matching Contribution as a Percentage of Compensation
1 (HCE)	10%	5%
2 (HCE)	10%	5%
3 (Non-HCE)	15%	7.5%
4 (Non-HCE)	10%	5%
5 (Non-HCE)	0%	0%
6 (Non-HCE)	0%	0%
7 (Non-HCE)	15%	7.5%

The actual contribution percentage for the highly compensated employees equals 5% (5% + 5% = 10%/2 = 5%). The average contribution percentage for the non-highly compensated employees is 4% (7.5% + 5% + 0% + 0% + 7.5% = 20%/5 = 4%). The matching contributions for the current plan year satisfy the 1.25 test because the contribution percentage for the highly compensated employees (5%) does not exceed 1.25 multiplied by the actual contribution percentage for the non-highly compensated employees (4%).

Example 3: Another employer also maintains a profit-sharing plan consisting solely of a CODA, under which employees may make elective contributions, up to a maximum of 20% of compensation. The plan defines compensation for testing purposes as gross pay before any salary reductions. The employer uses the prior year testing method. For the plan year ending December 31, 2024, there are 10 eligible employees, and four of them enter into salary reduction agreements as follows:

2024 Plan Year			
Eligible Employee	Compensation Before Salary Reduction	Elective Contributions	Actual Deferral Ratio
1	$70,000	$7,000	10% ($7,000/$70,000)
2	$60,000	$9,000	15% ($9,000/$60,000)
3	$30,000	$6,000	20% ($6,000/$30,000)
4	$25,000	$0	0% ($0/$25,000)
5	$20,000	$800	4% ($800/$20,000)
6	$18,000	$0	0% ($0/$18,000)
7	$15,000	$0	0% ($0/$15,000)
8	$12,000	$0	0% ($0/$12,000)
9	$10,000	$0	0% ($0/$10,000)
10	$8,000	$0	0% ($0/$8,000)

Employees 1 and 2 are 5% owners, and are therefore highly compensated employees under §414(q). For the preceding plan year (ending December 31, 2023), there was a somewhat different group of eligible employees. Employees 2, 5, 7, and 10 in the above example were not eligible employees in 2023. Employees 11 and 12 were eligible employees in 2023, but were no longer employed in 2024. In 2023, the only highly compensated eligible employee was Employee 1. The 2023 salary reduction elections were as follows:

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2023 Plan Year			
Eligible Employee	**Compensation Before Salary Reduction**	**Elective Contributions**	**Actual Deferral Ratio**
1	$60,000	$7,200	12% ($7,200/$60,000
3	$25,000	$5,000	20% ($5,000/$25,000)
4	$24,000	$4,800	20% ($4,800/$24,000)
6	$16,000	$0	0% ($0/$16,000)
8	$10,000	$0	0% ($0/$10,000)
9	$10,000	$0	0% ($0/$10,000)
11	$10,000	$2,000	20% ($2,000/$10,000)
12	$10,000	$1,000	10% ($1,000/$10,000)

The 2024 actual deferral percentage for the highly compensated employees is based on 2024 data. That percentage is 12.5% (10% + 15% = 25%/2 = 12.5%). The actual deferral percentage for the non-highly compensated eligible employees is determined using 2023 data. That percentage is 10% (20% + 20% + 0% + 0% + 0% + 20% + 10% = 70%/7 = 10%). This plan also meets the 1.25 test for the year 2024, because the actual deferral percentage for the highly compensated employees (12.5%) does not exceed 1.25 multiplied by the actual deferral percentage for the non-highly compensated employees (10%).

Practice Insight: Assuming that the employer continues to use prior year data in computing the actual deferral percentage for the non-highly compensated employees for the 2025 and subsequent plan years, the employer will know in early 2025 that this actual deferral percentage for the non-highly compensated employees will be only 3% for 2025 (20% + 0% + 4% + 0% + 0% + 0% + 0% + 0% = 24%/8 = 3%).

2. The 2.0 Test

The 2.0 test is satisfied if both of the following statements are true:

(1) The actual deferral percentage or the actual contribution percentage, as applicable, for the highly compensated employees does not exceed the actual deferral percentage or the actual contribution percentage, as applicable, for the non-highly compensated employees multiplied by 2.0, and

(2) The difference between the actual deferral percentage or the actual contribution percentage, as applicable, for the highly compensated employees and the actual deferral percentage or actual contribution percentage, as applicable, for the non-highly compensated employees is not more than two percentage points.[602]

Example 4: The plan described in *Example 1*, above, continues to have seven eligible employees during the plan year ending December 31, 2025. Again, the employer elects to compute the actual deferral percentage for the non-highly compensated employees for the current year and not the prior year. The results of the 2025 cash or deferred elections are as follows:

[602] §401(k)(3)(A)(ii)(II).

Eligible Employee	**Compensation Before Plan Contribution**	**Elective Contributions**	**Actual Deferral Ratio**
1	$100,000	$5,000	5% ($5,000/$100,000)
2	$100,000	$3,000	3% ($3,000/$100,000)
3	$35,000	$0	0% ($0/$35,000)
4	$30,000	$3,000	10% ($3,000/$30,000)
5	$25,000	$0	0% ($0/$25,000)
6	$20,000	$0	0% ($0/$20,000)
7	$15,000	$0	0% ($0/$15,000)

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Employees 1 and 2 are the only highly compensated employees and their actual deferral percentage is 4% (5% + 3% = 8%/2 = 4%). The actual deferral percentage for the non-highly compensated employees is 2% (0% + 10% + 0% + 0% + 0% = 10%/5 = 2%). The 2.0 test is satisfied in this case, because the actual deferral percentage for the highly compensated employees (4%) does not exceed the actual deferral percentage for the non-highly compensated employees (2%) multiplied by 2.0, and the difference between the percentages is not greater than two percentage points.

Example 5: A plan provides for employer matching contributions equal to 50% of all elective contributions, there are no after-tax employee contributions, the employer elects to compute the actual contribution percentage for the non-highly compensated employees for the current year and not the prior year, and the elective contributions and matching contributions represent the following percentages of pay in the current plan year:

Eligible Employee	**Elective Contribution as a Percentage of Compensation**	**Matching Contribution as a Percentage of Compensation**
1 (HCE)	7%	3.5%
2 (HCE)	1%	0.5%
3 (Non-HCE)	5%	2.5%
4 (Non-HCE)	0%	0%
5 (Non-HCE)	10%	5%
6 (Non-HCE)	0%	0%
7 (Non-HCE)	0%	0%

The actual contribution percentage for the highly compensated employees is 2% (3.5% + 0.5% = 4%/2 = 2%). The actual contribution percentage for the non-highly compensated employees is 1.5% (2.5% + 0% + 5% + 0% + 0% = 7.5%/5 = 1.5%). These percentages do not satisfy the 1.25 test, but they satisfy the 2.0 test because the actual contribution percentage for highly compensated employees (2%) does not exceed 200% of the actual contribution percentage for the non-highly compensated employees (1.5%), and the actual contribution percentage for highly compensated employees does not exceed the actual contribution percentage for non-highly compensated employees by more than two percentage points.

Example 6: Under the plan described in *Example 3*, above, only three of eight remaining eligible employees make elective contributions for the plan year ending December 31, 2025, as follows:

2025 Plan Year			
Eligible Employee	**Compensation Before Salary Reduction**	**Elective Contributions**	**Actual Deferral Ratio**
1	$70,000	$7,000	10% ($7,000/$70,000)
2	$60,000	$0	0% ($0/$60,000)
3	$30,000	$2,700	9% ($2,700/$30,000)
4	$25,000	$3,750	15% ($3,750/$25,000)
5	$20,000	$0	0% ($0/$20,000)
6	$18,000	$0	0% ($0/$18,000)
7	$15,000	$0	0% ($0/$15,000)
8	$12,000	$0	0% ($0/12,000)

The highly compensated employees for 2025 are Employees 1 and 2, who are 5% owners. Their actual deferral percentage is 5% (10% + 0% = 10%/2 = 5%). The actual deferral percentage for the non-highly compensated eligible employees, determined based on 2024 data illustrated under *Example 2*, above, is 3%. This plan satisfies the 2.0 test in 2025, because the actual deferral percentage for the highly compensated employees (5%) does not exceed the actual deferral percentage for the non-highly compensated employees (3%) multiplied by 2.0, and the difference between the two percentages is not greater than two percentage points.

Practice Insight: After the end of the 2025 plan year, the employer will know that the actual deferral percentage for 2026 for the non-highly compensated employees (absent an election to use current year data for that year) will be 4% (9% + 15% + 0% + 0% + 0% + 0% = 24%/6 = 4%). This will permit the high-

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ly compensated eligible employees to defer, on average, 6% in 2026.

Example 7: Five eligible employees participate in a plan which offers a salary reduction CODA and provides for discretionary employer contributions that meet the definition of qualified nonelective contributions. Employees 1 and 2 are highly compensated employees. The employer elects to compute the actual deferral percentage for the non-highly compensated employees for the current year and not the prior year. For the 2014 plan year, the following contributions were made:

Employee	Compensation	Elective Contributions	Nonelective Contributions	ADR w/o QNEC	ADR with QNEC
1	$100,000	$9,000	$5,000	9%	14%
2	$90,000	$9,000	$4,500	10%	15%
3	$60,000	$9,000	$3,000	15%	20%
4	$30,000	$0	$1,500	0%	5%
5	$30,000	$2,000	$1,500	6.67%	11.67%

Without taking into account the QNECs, the plan fails both the 1.25 test and the 2.0 test as follows: The actual deferral percentage for the highly compensated employees (Employees 1 and 2) and non-highly compensated employees (Employees 3, 4, and 5), without taking into account the QNECs, are 9.5% (9% + 10% = 19%/2 = 9.5%) and 7.22% (15% + 0% + 6.67% = 21.67%/3 = 7.22%), respectively. Since 9.5% is greater than both 1.25 × 7.22% (9.03%), and 7.22% + 2.00 (9.22%), the elective contributions, taken alone, do not pass the nondiscrimination test. However, by taking into account the QNECs, the actual deferral percentage for the highly compensated employees and non-highly compensated employees are 14.5% (14% + 15% = 29%/2 = 14.5%) and 12.22% (20% + 5% + 11.67% = 36.67%/3 = 12.22%), respectively. Since 14.5% is less than 1.25 times 12.22% (15.28%), the plan passes the 1.25 test when QNECs are taken into account.

K. Variables Affecting Compliance with the ADP and ACP Tests

In many cases, it will be difficult to know before the end of a plan year whether the ADP or ACP tests have been satisfied for the year. Employees may change their plan elections during the course of a year, or their employment may terminate, and new employees may become eligible during the year and make new elections. Where employers use prior year data in determining the actual deferral percentage and/or actual contribution percentage of the non-highly compensated employees, that percentage will not fluctuate based on events during the current plan year, but there will still be variation and unpredictability in the actual deferral percentage and actual contribution percentage for the highly compensated employees.

Example: Under a profit-sharing plan that provides solely for elective contributions, and for which the employer elects to use current year data in computing the actual deferral percentage for the non-highly compensated employees, the following eligible employees have elections in effect at the beginning of the 2024 plan year under which their monthly salary will be reduced by an amount equal to the following percentage (the plan includes elective contributions in the definition of "compensation" for purposes of the ADP tests):

Eligible Employee	Annual Rate of Salary	Percentage Reduction (Anticipated Deferral Ratio)
1	$120,000	10%
2	$115,000	0%
3	$30,000	3%
4	$25,000	15%
5	$20,000	3%
6	$15,000	0%
7	$12,000	0%
8	$10,000	0%
9	$8,000	0%

The plan is expected to satisfy the 2.0 test, because the actual deferral percentage for the highly compensated employees (Employees 1 and 2) is expected to be 5%, and the actual deferral percentage for the non-highly compensated employees is expected to be 3%. If, however, Employee 4 decides at the end of the second month to terminate his salary reduction election because he needs the additional cash, his deferral percentage will drop from 15% to 2.5% and the plan will cease to satisfy the 2.0 test. The plan would also fail to satisfy the 2.0 test if Employee 2 began elective contributions during the year, or if one or more non-highly compensated employees became eligible and elected no contributions.

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L. *Measures to Help Assure Compliance with the ADP and ACP Tests*

While noncompliance with the 1.25 and 2.0 tests can be cured by returning excess contributions and excess aggregate contributions after the end of the plan year, as described below in III.M., it is still desirable to comply with the test at the outset and to avoid the administrative cost and risk associated with making corrections.

1. *How to Utilize Additional Nonelective Employer Contributions to Comply with the ADP and ACP Tests*

As described above in detail,[603] an employer may comply with the 1.25 or 2.0 tests by making additional employer contributions, or shifting contributions from the ADP test to the ACP test (or vice versa), in order to increase the actual deferral percentage of the non-highly compensated employees and pass the ADP test, or increase the actual contribution percentage of non-highly compensated participants and pass the ACP test.[604] These contributions have to be "qualified," i.e., nonforfeitable when allocated to participant accounts and subject to the distribution restrictions applicable to elective contributions under §401(k)(2)(B)(1) (i.e., generally, a distribution may not be made before severance from employment, death, disability, age 59½, hardship, or plan termination).[605] Further, these contributions would need to satisfy the prohibition against disproportionate contributions described above in III.H.2. and III.I.2. In addition, the regulations imply that a plan must by its terms provide for the additional nonelective contributions in order for them to be taken into account.[606]

There are generally three types of nonelective employer contributions that may be made to a plan containing a CODA. The most common is a matching contribution, i.e., a contribution based on the amount of elective contributions or employee after-tax contributions made for each employee.[607] Another type of contribution is a nonelective contribution, provided only if, and to the extent, needed to assure compliance with the ADP or ACP tests. This is referred to as a compliance contribution below. Finally, a plan may provide for nonelective contributions unrelated to the CODA itself, e.g., an annual profit-sharing contribution that represents the same percentage of pay for all eligible employees. Some plans provide for two, or even all three, of the foregoing types of employer contributions.

Because the regulations require that nonelective contributions be made no later than 12 months after the end of the plan year during which they are to be counted as contributions for purposes of the ADP or ACP tests,[608] an employer is accorded the flexibility of testing the plan after year end and then deciding whether to make additional contributions. If a plan fails the test but corrective distributions or forfeitures are not made within 2½ months (six months in the case of an eligible automatic contribution arrangement) following the end of the plan year, the employer should compare the cost of distributing the excess contributions and/or excess matching contributions and paying the 10% excise tax under §4979[609] with making an additional qualified matching or nonelective contribution sufficient to allow the plan to pass the test (taking into account the benefit such additional contributions provide to participants).

Practice Insight: The general rules governing the tax deductibility of contributions under §404(a)(3) apply to the qualified contributions, making it advantageous to make the contributions before the employer's tax return deadline (with extensions) for the tax year in which the plan year ends.[610]

Of course, passing the ADP and ACP tests may be achieved through a combination of corrective distributions and additional contributions.[611]

a. *Utilizing Compliance Contributions to Comply with the ADP and ACP Tests*

Some plans permit or require the employer to make contributions for a plan year, at or after the end of the plan year, in such amounts as will permit the 1.25 or 2.0 test to be satisfied. These contributions are generally made only for the benefit of non-highly compensated employees, although they might be made for all eligible employees. They are generally made and allocated in proportion to compensation, but other nondiscriminatory approaches are permissible, including allocation on a per capita basis (with each participant being allocated the same dollar amount).

Practice Insight: Depending upon the circumstances, the same aggregate employer contribution may result in a higher actual deferral percentage or actual contribution percentage for the non-highly compensated employees under one approach versus another.

If this provision for special, nonelective employer contributions is the only measure used under the plan, and if no limit is placed on the deferral elections of the highly compensated employees, significant expense could result for the employer.

> *Example:* The actual deferral percentage for highly compensated employees is 12.5% for a plan year, and the actual deferral percentage for the non-highly compensated employees is only 4% taking into account only elective contributions. If the plan only allows the employer to make a contribution in order to comply with the ADP test, the employer would have to contribute another 6% of compensation for the non-highly compensated employees to comply with the 1.25 test (unless the test can be satisfied with a smaller contribution allocated on a per capita or other basis).
>
> Consequently, a plan document should contemplate all compliance mechanisms offered under the statute and regulations.

[603] *See* III.H.2. and III.I.2., above.
[604] Reg. §1.401(k)-2(b)(1)(i)(A), §1.401(m)-2(b)(1)(i)(A).
[605] Reg. §1.401(k)-6, §1.401(m)-5.
[606] Reg. §1.401(k)-2(b)(1)(i), §1.401(m)-2(b)(1)(i).
[607] See I.D.2., above, for a definition of matching contributions.
[608] See III.H.2 and III.I.2., above, for further discussion of this timing rule.
[609] See III.M.9., below, for a discussion of the excise tax under §4979.
[610] §404(a)(6).
[611] Reg. §1.401(k)-2(b)(1)(ii), §1.401(m)-2(b)(1)(ii).

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b. Utilizing Matching Contributions to Comply with the ADP and ACP Tests

The most common type of nonelective employer contribution made under a plan containing a CODA is a matching contribution. Matching contributions can help a plan comply with the ADP and ACP tests because they provide an incentive to eligible employees (especially non-highly compensated employees) to make elective contributions under the plan. A plan might, for example, provide for matching employer contributions equal to 25% or 50% of the amount of the elective contributions made by each eligible employee.

In addition, matching contributions are often made nonforfeitable and subject to the distribution restrictions applicable to elective contributions (e.g., distributions may not be made before age 59½ in circumstances other than death, disability, or severance from employment) so that they may be taken into account in applying the ADP test as qualified matching contributions. See III.H.2., above, for a discussion of taking matching contribution into account under the ADP test.

Practice Insight: If a matching contribution is taken into account for purposes of the ADP test, then it is not taken into account for purposes of the ACP test.[612]

Under some CODAs, especially those maintained by very large employers, matching contributions do not need to be taken into account in applying the ADP test. In these cases, the employer may wish to subject those contributions to a vesting schedule rather than making them immediately nonforfeitable. This would tend to reduce the employer's cost, provide an incentive to employees to remain with the employer for some period of time, and permit the matching contributions to be free of the elective contribution distribution restrictions.

c. Utilizing Other Nonelective Employer Contributions to Comply with the ADP and ACP Tests

Many plans also provide for nonelective employer contributions that are independent of elective contributions made under the plan. For example, some traditional profit-sharing plans, providing solely for annual nonelective employer contributions made at the discretion of the employer and allocated among all eligible employees in proportion to compensation, have been amended to include CODAs in addition to the annual profit-sharing contributions.

An employer may be able to take into account part or all of the nonelective employer contributions in order to satisfy the ADP or ACP test, however; the same QNECs cannot be taken into account for purposes of both the ADP and ACP tests. See III.H.2. and III.I.2., above, for discussions of taking QNECs into account for purposes of the ADP and ACP tests.

> *Example:* If, taking into account only the elective contributions under the CODA, the actual deferral percentage for the highly compensated employees is 3%, and the actual deferral percentage for non-highly compensated employees is 1%, neither the 1.25 nor the 2.0 test will be satisfied. If the nonelective contributions represent 1% or more of compensation, and if they are nonforfeitable and satisfy the elective contribution distribution restrictions under §401(k)(2)(B)(1) (i.e., generally, a distribution may not be made before severance from employment, death, disability, age 59½, hardship, or plan termination), combining them with the elective contributions will permit compliance with the 2.0 test.

As noted above in the context of matching contributions, instead of ensuring that the nonelective contributions can be utilized in the ADP or ACP tests, an employer may prefer to make a nonelective employer contribution subject to a vesting schedule or to permit withdrawals before age 59½ in circumstances other than disability or severance from employment.

2. Limiting Amounts Subject to Deferral to Ensure Compliance with the ADP and ACP Tests

One way of assuring that the ADP and ACP tests will be satisfied is to limit the amount subject to deferral and, if necessary, to provide for a minimal level of qualified nonelective employer contributions (i.e., fully vested and subject to the elective contribution distribution restrictions). As an extreme example, if: (i) a profit-sharing plan provided for nonelective employer contributions equal to 2% of compensation; (ii) those contributions were fully vested and subject to the elective contribution restrictions on distribution; and (iii) highly compensated employees were limited to deferring only an additional 2% of compensation, the 2.0 test would be satisfied in all cases. Even if each of the highly compensated employees chose to make the maximum 2% elective contribution, thus benefiting from a total 4% contribution, and none of the non-highly compensated employees elected to defer any amount beyond the 2% nonelective employer contribution, the actual deferral percentages of 4% and 2%, respectively, would satisfy the 2.0 test.

If, in practice, non-highly compensated employees elect to defer amounts in addition to the 2% nonelective contribution, the limit on elective contributions by the highly compensated could be substantially greater than 2% — perhaps as high as 5% or 6% — without jeopardizing compliance with the ADP tests, and no limit may be necessary at all. Alternatively, the 2% nonelective employer contribution could be reduced or eliminated in many cases where the limit on elective contributions was sufficient, standing alone, to assure compliance with the ADP tests.

Practice Insight: Catch-up contributions are not limited to contributions that exceed a statutory limit, but include contributions that exceed a plan-design limit (such as the one described above).[613] As a result, some employers limit the amount subject to deferral but provide for catch-up contributions in excess of the limit. Since catch-up contributions are not taken into account under the ADP test, this approach has the virtue of facilitating compliance with the ADP test while allowing catch-up eligible participants who may be more likely to be HCEs because they are older participants to defer more than the employer-specified limit. To affect ACP compliance, the employer could also exclude catch-up contributions from the match.

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[612] Reg. §1.401(m)-2(a)(5)(iii).

[613] §414(v)(3)(A)(ii); Reg. §1.414(v)-1(f)(2). *See* VIII., below.

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Although a limit on elective contributions will indirectly affect ACP testing by affecting the match earned on such elective contributions, for purposes of ACP test compliance, a plan may simply limit the match to an amount that complies with ACP testing.[614]

3. *Tracking the Elections During the Year to Ensure Compliance with the ADP and ACP Tests*

Many employers monitor compliance with the ADP and ACP tests during the course of a year. If provided for in the plan, the employer can make automatic adjustments to the elections of highly compensated employees to the extent necessary to assure compliance, or inform the affected employees of the likelihood of excess contributions or excess aggregate contributions and allow them to make appropriate adjustments, if they desire. Where the former approach can be used because the plan provides for it, the salary reduction agreement will have to provide for automatic adjustments to be made to elective contributions by the employer, directly or by reference to the plan document.

> *Example:* A profit-sharing plan includes elective contributions. Each month, the plan administrator projects the compensation and elective contributions for each highly compensated eligible employee for the plan year, based upon compensation and contributions made to date during the plan year and projected pay levels and contributions for the remainder of the year. If current year data is used in determining the actual deferral percentage and/or actual contribution percentage of the non-highly compensated eligible employees, the same projections are done for those employees as well. If the administrator determines, based upon these projections, that the 1.25 and 2.0 tests will not be satisfied for the plan year, the administrator is authorized by the plan to reduce unilaterally the elective contributions for the highly compensated employees (and to increase their current salary accordingly) for the balance of the plan year, to the extent necessary to satisfy either the 1.25 or 2.0 test, and to limit matching contributions, to the extent necessary to satisfy either the 1.25 or 2.0 test. The plan might provide that those highly compensated participants with elections to defer a higher percentage of compensation will have their elective contributions reduced first, so that no highly compensated participant's elective contributions will be reduced so long as any other highly compensated participant has a higher rate of elective contributions in effect. For example, highly compensated participants whose elective contributions represent 15% of compensation will be reduced to 14%, and they and others whose elective contributions represent 14% will then be reduced to 13%, and so on, until the actual deferral percentage and/or actual contribution percentage for the highly compensated employees is reduced to a level that will satisfy either the 1.25 or 2.0 test. Alternatively, the plan might provide for a pro rata dollar reduction in the elective contributions for all highly compensated eligible employees. In addition, the calculation of reductions might take into account elective contributions already made during the plan year, to avoid penalizing participants who are electing higher percentages of contributions at the time of the reductions than they elected for earlier months.

Practice Insight: When allocating excess contributions to correct a failed ADP test, a plan must first allocate the excess to the highly compensated employees with the highest dollar amount of elective contributions,[615] but there is no requirement that an employer use the same approach in reducing deferrals prospectively in an effort to satisfy the ADP test.

4. *Nonqualified Deferred Compensation Plans Used to Ensure Compliance with the ADP and ACP Tests*

Many employers establish nonqualified deferred compensation plans for a select group of their highest paid employees as an alternative to, or in addition to, participation in a qualified CODA. The nonqualified plan typically offers the option to defer up to the same maximum percentage of pay as the qualified CODA, the same level of matching contribution, and the same or similar investment options. The nonqualified plan will, however, typically permit deferrals to exceed the §402(g) elective deferral limit and allow both deferrals and matching contributions to be made with respect to compensation in excess of the §401(a)(17) limit. The nonqualified plan might be designed to be more attractive in other respects as well, such as higher percentage deferrals, higher levels of match and more alternative investment options.

To permit tax to be deferred on the elective contributions and match, the investments made under the plan are typically held in the name of the employer, or in a grantor trust (often called a "rabbi" trust), in either case subject to the claims of the employer's general creditors. In addition, to avoid accelerated tax and additional penalties, the plan must comply with §409A. See 385 T.M., *Deferred Compensation Arrangements*, for a more detailed discussion of the requirements that apply to nonqualified plans.

In order to comply with ERISA, such a nonqualified plan must be limited to a "select group of management or highly compensated employees."[616] The Department of Labor has not defined this term; however, DOL has expressed its view that this "select group" or "top hat" exemption should be interpreted in light of congressional intent to limit the provision to individuals who, by virtue of their position or compensation level, have the ability to affect or substantially influence the design and operation of the plan.[617]

If the nonqualified plan can be made sufficiently attractive so that eligible executives are willing to forgo the extra protections of the qualified plan (the assets of which are held in trust and are not subject to the claims of the employer's general creditors) some of the eligible executives will forgo participation in the qualified plan, thus reducing the actual deferral percentage and actual contribution percentage for the highly compensated participants and improving chances of compliance with the ADP and ACP tests. Even if this objective is not achieved, the

[614] Reg. §1.401(m)-2(b)(1)(ii).

[615] See III.M.1., below, for a discussion of allocating excess contributions.

[616] ERISA §201(2), §301(a)(3), §401(a)(1); 29 C.F.R. §2520.104-23.

[617] DOL Adv. Op. 90-14A.

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nonqualified plan at least offers the eligible executives the opportunity to defer amounts in excess of what the ADP and ACP tests allow them to defer under the qualified plan.

In a 1995 private letter ruling, the IRS approved an arrangement that made it easier for executives to maximize their deferrals and matching contributions under the qualified CODA while leaving the balance deferred under a nonqualified plan.[618] That ruling described an arrangement under which, before the beginning of the plan year, the executive elected the total amount to be deferred under the qualified CODA and nonqualified plan combined, and also elected whether the amount ultimately eligible for contribution to the qualified CODA (determined after application of the ADP and ACP tests after year end) would be contributed to the qualified CODA or distributed to the executive in cash. The balance was deferred under the nonqualified plan.

M. Correcting a Failed ADP or ACP Test

As described above, a plan must pass the ADP and ACP tests, unless it satisfies a design-based safe harbor. If a plan fails the ADP and ACP tests, corrective measures must be taken, or the plan faces a tax-qualification failure.[619] This section describes corrective distributions, forfeitures, and recharacterizations. A plan cannot be amended retroactively to correct ADP or ACP testing failures.[620] See III.L.1., above, for a discussion of using compliance contributions to correct a failed test.

1. Calculating and Allocating Excess Contributions to Correct a Failed ADP Test

If a plan still fails the ADP test after taking into account any or all qualified nonelective contributions and qualified matching contributions that are to be made, the plan must either distribute the excess contributions (plus allocable income) or, if the plan allows employee after-tax contributions, it may recharacterize the excess contributions as after-tax contributions and retest the employee contributions under the ACP test.[621] A combination of these methods may also be used.[622] Excess contributions may not remain unallocated or be allocated to a suspense account for reallocation in a future year.

Practice Insight: Computing the amount of the excess contributions for each highly compensated employee, and determining the investment income allocable to it, involves a substantial administrative burden and cost. More important, if a mistake is made, the plan may be disqualified. If too much is distributed, the excess distribution will, in most cases, violate the distribution restrictions applicable to elective contributions under §401(k)(2)(B)(1). If too little is distributed, the plan will have failed to correct the ADP test failure. Accordingly, various steps may be desirable to help assure compliance with the ADP test without relying on the curative measure of distributing excess contributions. However, if a failure does occur, the plan sponsor should determine if a correction procedure is available to cure the failure and restore the plan's qualified status. IRS correction procedures are described in 375 T.M., *EPCRS — Plan Correction and Disqualification.*

A plan must first identify the total amount of excess contributions which must either be returned or recharacterized, and then the plan must determine how that total amount of excess contributions will be allocated among HCEs.

To determine the total amount of excess contributions, the individual deferral percentages of the highly compensated employees with the highest deferral percentages are reduced until the actual deferral percentage for all highly compensated employees falls within the limits of the 1.25 or 2.0 test.[623] In other words, an employer must first take the HCE with the highest actual deferral ratio or ADR and calculate the amount that would be required to reduce that HCE's ADR until either the plan passes the 1.25 or 2.0 test, or that HCE's ADR equals the ADR of the HCE with the next highest ADR. The employer should continue to calculate the amounts required to reduce the ADR until the ADP for the group passes the ADP test.

Example: An employer maintaining a qualified CODA had 10 eligible employees, four of whom were highly compensated. The employees elected the following rates of deferral for the plan year:

Eligible Employee	Compensation Before Deferrals	Deferral Percentage (ADR)
1	$100,000	9%
2	$100,000	9%
3	$100,000	6%
4	$100,000	0%
5	$25,000	10%
6	$25,000	0%
7	$20,000	5%
8	$20,000	3%
9	$18,000	0%
10	$15,000	0%

The actual deferral percentage for the four highly compensated employees (Employees 1, 2, 3, and 4, above) was 6% (9% + 9% + 6% + 0% = 24%/4 = 6%). The actual deferral percentage for the non-highly compensated employees was 3% (10% + 0% + 5% + 3% + 0% + 0% = 18%/6 = 3%). These actual deferral percentages satisfy neither the 1.25 test nor the 2.0 test. To satisfy one of these tests (the 2.0 test), the actual deferral percentage for the highly compensated employees had to be reduced to 5%. If the individual deferral percentages for Employees 1 and 2 above

[618] PLR 9530038. *See also* PLR 9524007, PLR 9752017, PLR 9752018, PLR 9807010, PLR 9807027, and PLR 200012083. For further discussion of "wrap-around" arrangements, see 385 T.M., *Deferred Compensation Arrangements.*

[619] Reg. §1.401(k)-2(b)(1), §1.401(m)-2(b)(1). See IX., below, for a discussion of nonqualified CODAs.

[620] Reg. §1.401(a)(4)-11(g)(3)(vii).

[621] Reg. §1.401(k)-2(b)(3).

[622] Reg. §1.401(k)-2(b)(1)(ii).

[623] §401(k)(8)(B)(ii) and pre-2006 Reg. §1.401(k)-1(f)(2).

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were reduced to 7%, the actual deferral percentage for the highly compensated employees as a group would be 5%. Accordingly, the excess contributions totaled those contributions for Employees 1 and 2 in excess of 7% of their compensation.

Practice Insight: For plan years beginning before 1997, the method described above was used to both calculate total excess contributions and allocate such excess contributions. In view of the dollar limit on elective deferrals under §402(g),[624] deferrals by the lower-paid highly compensated employees were likely to be cut back before those of the higher-paid highly compensated employees. For example, a $9,000 elective deferral resulted in a deferral percentage of 10% for an employee earning $90,000, while the same elective deferral resulted in a 6% deferral percentage for an employee earning $150,000. Because of this perceived unfairness in the allocation of excess contributions, Congress changed the method of allocation for plan years beginning after December 31, 1996.[625] Once the total excess contributions have been calculated, the total excess contributions are then allocated first to the highly compensated employees with the highest dollar amounts of contributions, so that those with the highest dollar amount of contributions have excess contributions refunded (or recharacterized) before those with lower dollar amounts of contributions.[626]

Example: An employer maintaining a qualified CODA has four highly compensated eligible employees whose elective deferrals for the plan year, are as follows:

Eligible Employee	Compensation Before Reduction	Elective Contributions	Deferral Percentage (ADR)
1	$150,000	$9,000	6%
2	$120,000	$9,000	7.5%
3	$100,000	$9,000	9%
4	$80,000	$8,000	10%

The actual deferral percentage for the non-highly compensated employees is 4%, and thus the maximum permitted actual deferral percentage for the highly compensated employees is 6%. The actual deferral percentage before distribution (or recharacterization) of excess contributions is 8.13% (6% + 7.5% + 9% + 10% = 32.5%/4 = 8.13%). In order to calculate total excess contributions, the deferral percentages or ADR for Employees 2, 3, and 4 would each be reduced to 6%, for a reduction of $1,800, $3,000, and $3,200, respectively. The total excess contribution equals $8,000.

The $8,000 is then allocated among the employees based upon dollar amounts of contributions. Employees 1, 2, and 3 are each reduced by $1,000 before any reduction is made in Employee 4's deferrals. Then, all four employees are reduced by $1,250 to a level of $6,750 in each case.

Practice Insight: No retesting is required after these dollar reductions, even though the resulting percentages do not satisfy the ADP tests. In the above example, the ADP tests would not be satisfied by a $6,750 elective deferral for each of the four highly compensated employees. That contribution would result in the following deferral percentages:

Eligible Employee	Compensation Before Reduction	Elective Contributions	Deferral Percentage
1	$150,000	$6,750	4.5%
2	$120,000	$6,750	5.63%
3	$100,000	$6,750	6.75%
4	$80,000	$6,750	8.44%

The average deferral percentage would be 6.33% (4.5% + 5.63% + 6.75% + 8.44% = 25.32%/4% = 6.33%), compared to 4% for the non-highly compensated employees. Notwithstanding this fact, the CODA will be treated as satisfying the ADP tests after refunds (or recharacterizations) reduce the contributions to $6,750 for each of the highly compensated eligible employees.[627]

If matching or other nonelective employer contributions are taken into account in applying the ADP test, these contributions are also taken into account in determining the excess contributions.[628]

Any previously distributed excess deferral under §402(g) for the tax year ending with or within the plan year reduces the amount of excess contribution that may be distributed or recharacterized.[629]

2. *Calculating and Allocating Excess Aggregate Contributions to Correct a Failed ACP Test*

If a plan still fails the ACP test after taking into account any or all qualified nonelective contributions that are to be made, the plan must distribute the "excess aggregate contributions" (plus allocable income). The excess aggregate contributions for any plan year means the excess of the matching contributions and after-tax employee contributions, together with any QNECs or elective contributions taken into account in computing contribution percentages under §401(m), actually made on behalf of highly compensated employees for the plan year, over the maximum amount of such contributions permitted under the ACP test.[630] As in determining excess contributions after a failed ADP test,[631] the excess aggregate contributions for the highly compensated as a group is determined by reducing con-

[624] *See* VII., below.
[625] §401(k)(8)(C); Reg. §1.401(k)-2(b)(2)(iii).
[626] §401(k)(8)(C); Reg. §1.401(k)-2(b)(2)(iii); *see also* Notice 97-2.
[627] Reg. §1.401(k)-2(b)(4)(iv).
[628] See the definition of "actual deferral ratio" under §1.401(k)-6, which references §1.401(k)-2(a)(3).
[629] Reg. §1.401(k)-2(b)(4)(i)(B), §1.402(g)-1(e)(6).
[630] §401(m)(6)(b).
[631] *See* III.M.1., above.

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tributions made on behalf of highly compensated employees in order of their contribution percentages, beginning with the highest contribution percentages.[632] That total amount is then allocated first to the highly compensated employees with the highest dollar amounts of contributions, so that those with the highest dollar amount of contributions have excess contributions distributed (or forfeited) before those with lower dollar amounts of contributions.[633] See III.M.1., above, for a detailed discussion of reducing and allocating contributions.

Practice Insight: No retesting is required after these dollar reductions, even if the resulting percentages do not satisfy the ACP test.[634]

3. Determining the Income Allocable to Excess Contributions and Excess Aggregate Contributions

a. Reasonable and Alternative Methods of Calculating Income Allocable to Excess Contributions and Excess Aggregate Contributions

Any income allocable to any excess contributions and excess aggregate contributions earned during the plan year in which testing was failed must also be distributed.[635]

Under the regulations, a plan may use any "reasonable method" for determining the amount of income allocable to excess contributions, so long as the method: (1) does not violate the general nondiscrimination rule of §401(a)(4);[636] (2) is used consistently for all participants and for all corrective distributions under the plan for the plan year; and (3) is used by the plan for allocating income to participants' accounts generally.[637]

In addition to the general rule for determining allocable income, the regulations provide an alternative method.[638] The regulations do not require the plan terms to specify which method is to be used.

Under the alternative method for excess contributions, a plan may first determine the entire amount of income for the plan year allocable to elective contributions and amounts treated as elective contributions. This amount is then multiplied by a fraction, the numerator of which is the excess contributions for the plan year for the employee, and the denominator of which is the sum of the total employee account balance attributable to elective contributions and amounts treated as elective contributions as of the beginning of the plan year, plus the employee's elective contributions and amounts treated as elective contributions for the plan year.

Example: A profit-sharing plan includes a salary reduction CODA only. As of January 1, 2024, a highly compensated employee's account balance is $50,000. During 2024, she made $7,000 of elective contributions, $1,000 of which is determined to be an excess contribution. If the account earned $5,000 of income during 2024, the allocable income determined under the alternative method would be $87.72, as follows:

$5,000 × ($1,000/($50,000 + $7,000)) = $87.72.

Under the alternative method for excess aggregate contributions, the income allocable to excess aggregate contributions for the plan year may be determined by multiplying the income for the plan year allocable to employee contributions, matching contributions, and amounts treated as matching contributions by a fraction. The numerator of the fraction is the amount of excess aggregate contributions made on behalf of the employee for the plan year. The denominator of the fraction is the sum of the total account balance of the employee attributable to employee contributions, matching contributions, and amounts treated as matching contributions as of the beginning of the plan year, plus the amount of such contributions for such employee for the plan year.

Practice Insight: The alternative method is likely to produce a higher amount of income than a reasonable method which assumes that the excess contributions and excess aggregate contributions were made last and, therefore, later in the plan year.

b. Gap Period Income for Excess Contributions and Excess Aggregate Contributions

Income earned on excess contributions and excess aggregate contributions after the end of the plan year being tested, but before the date of distribution of such contributions ("gap period income"), is not required to be distributed. The requirement to distribute gap period income was eliminated for plan years beginning on or after January 1, 2008.[639]

Gap period income has a fairly convoluted history, which is helpful to understand when reviewing previous plan amendments. Prior to final §401(k) regulations that were generally effective for plan years beginning on or after January 1, 2006, a plan was permitted, but not required, to distribute gap period income along with excess contributions, or excess aggregate contributions, and income earned through the end of the plan year.[640] The 2006 final regulations, however, required the distribution of gap period income.[641] Congress reversed the change as part of the 2006 PPA.[642] Final regulations implementing the 2006 PPA change did not, however, revert to the pre-2006 regime, and instead prohibit the payment of gap period income.[643] Thus, it appears that a plan may not distribute gap period income since such a provision, absent regulatory relief, would ordinarily run afoul of the in-service distribution restrictions.

[632] §401(m)(6)(B); Reg. §1.401(m)-2(b)(2)(ii).

[633] §401(m)(6)(C); Reg. §1.401(m)-2(b)(2)(iii).

[634] Reg. §1.401(m)-2(b)(3)(vi).

[635] Reg.§401(k)(8)(A) and Reg. §1.401(k)-2(b)(2)(i); §401(m)(6)(A) and Reg. §1.401(m)-2(b)(2)(i).

[636] See 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*, for a discussion of the §401(a)(4) nondiscrimination requirements.

[637] Reg. §1.401(k)-2(b)(2)(iv)(B), §1.401(m)-2(b)(2)(iv)(B).

[638] Reg. §1.401(k)-2(b)(2)(iv)(C), §1.401(m)-2(b)(2)(iv)(C).

[639] Pub. L. No. 109-280, §902(e)(3)(B)(i).

[640] Pre-2006 Reg. §1.401(k)-2(b)(2)(iv).

[641] Reg. §1.401(k)-2(b)(2)(iv)(D).

[642] Pub. L. No. 109-280, §902(e)(3).

[643] Reg. §1.401(k)-2(b)(2)(iv)(A).

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4. *Distribution of Excess Contributions to Correct a Failed ADP Test*

A plan will not fail the ADP test for any plan year if, before the end of the following plan year, any excess contributions, and allocable income, are distributed.[644] These distributions may be made notwithstanding the distribution restrictions applicable to elective contributions or "any other provision of law."[645] In addition, these distributions are exempt from the 10% penalty tax of §72(t) on early distributions[646] and from any participant or spousal consent requirements.[647]

Practice Insight: An excess contribution may qualify as a catch-up contribution under §414(v), in which case such contribution does not need to be (and, in fact, cannot be) distributed. However, such a contribution retains its character as an excess contribution, for example, for purposes of determining whether matching contributions may be forfeitable if matching contributions are not made on catch-up contributions. Catch-up contributions are discussed in VIII., below.

The regulations also provide that any distributed excess contributions must be designated as such by the employer.[648] The excess will be treated as an employer contribution to the plan for purposes of the deduction rules under §404 and the limitation on annual additions under §415.[649]

The regulations modify the timing rule in the statute somewhat by requiring the distribution of excess contributions to be made after the close of the plan year being tested and before the expiration of 12 months thereafter.[650] However, see III.M.9., below, for a discussion of the excise tax that applies under §4979 if the excess contributions are not distributed within 2½ months after the end of the plan year.

Practice Insight: Because the statute requires that the distribution be made "before the close of the following plan year," employers should be cautious about relying on the 12-month rule in the event of a change in plan year resulting in a short plan year of less than 12 months following the plan year for which the excess contributions were made. Where a plan is terminated during a plan year in which the excess contributions arose, the regulations require corrective distributions to be made as soon as administratively feasible after the date of termination, but in any event within 12 months after such date.[651]

If the entire account balance of a highly compensated employee is distributed before the excess contributions are distributed, the distribution is deemed to have been a corrective distribution of excess contributions (and income) to the extent such a distribution would otherwise have been required (presumably with respect to that employee).[652] Any distribution to an HCE of less than the entire amount of excess contributions and allowable income is treated as a pro rata distribution of excess contributions and allocable income.[653] The 2006 regulations do not explicitly address the issue but an example in the pre-2006 regulations indicates that if the employee withdraws less than the entire account balance, corrective distributions will be required in addition (up to the amount of the remaining account balance).[654] The example further states that the portion of the distribution that is deemed to be corrective must be reported as such on a separate Form 1099-R, presumably in order to comply with the regulatory rule that the plan designate a corrective distribution as such.

For a participant over age 73, any distribution of an excess contribution does not count toward any required minimum distribution under §401(a)(9).[655]

Practice Insight: It is not clear whether the excess contribution is also excluded from the account balance used to calculate the required minimum distribution, although this would be logical.

A plan may prescribe a default rule for determining whether a distribution of an excess contribution is to be attributed to pre-tax elective contributions or designated Roth contributions in situations where an HCE has made both types of elective contributions.[656] The default rule might treat such distributions as entirely attributable to either pre-tax or Roth elective contributions or as allocated in the proportion that such contributions were made to the plan. Further, a plan may permit an HCE with both types of elective contributions to elect whether the corrective distribution should be attributed to pre-tax or Roth elective contributions.[657]

5. *Recharacterization of Excess Contributions to Correct a Failed ADP Test*

If a plan allows for after-tax contributions, the plan may correct an ADP test failure by recharacterizing excess contributions as after-tax contributions.[658] Recharacterization may be mandated by the plan, or highly compensated employees with excess contributions may be offered a choice.[659]

Recharacterized excess contributions must be reported by the plan administrator as employee after-tax contributions and, for purposes of the nondiscrimination provisions and for §72 (tax basis) and §401(m) (ACP testing), must be accounted for as after-tax contributions by the employee.[660] For all other purposes under the Code, however, including §404 (ability for an employer to take deductions), §409, §411 (vesting), and §415 (annual limits), recharacterized excess contributions are treated as employer contributions that are elective contributions.[661]

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[644] §401(k)(8)(A)(i).

[645] §401(k)(8)(A).

[646] §401(k)(8)(D).

[647] Reg. §1.401(k)-2(b)(2)(vii)(A).

[648] Reg. §1.401(k)-2(b)(2)(v).

[649] Reg. §1.401(k)-2(b)(2)(vii)(B).

[650] Reg. §1.401(k)-2(b)(2)(v).

[651] Reg. §1.401(k)-2(b)(2)(v).

[652] Reg. §1.401(k)-2(b)(2)(v).

[653] Reg. §1.401(k)-2(b)(2)(vii)(D).

[654] Pre-2006 Reg. §1.401(k)-1(f)(7) *Ex.* 2.

[655] Reg. §1.401(k)-2(b)(2)(vii)(C), as amended by T.D. 10001, 89 Fed. Reg. 58,886 (July 19, 2024) (updating required minimum distribution regulation reference). *See* §401(a)(9)(C), as amended by Pub. L. No. 116-94, Div. O, §114(b) (increasing age to age 72), effective for individuals who attain age 70½ after December 31, 2019, and by Pub. L. No. 117-328, Div. T, §107(b) (increasing age to age 73 and later to age 75), effective for individuals who attain age 72 after December 31, 2022.

[656] Reg. §1.401(k)-2(b)(1)(ii); Preamble to T.D. 9237, 71 Fed. Reg. 6 (Jan. 3, 2006).

[657] Reg. §1.401(k)-2(b)(1)(ii).

[658] §401(k)(8)(A)(ii), Reg. §1.401(k)-2(b)(3).

[659] Reg. §1.401(k)-2(b)(1)(ii).

[660] Reg. §1.401(k)-2(b)(3)(ii).

[661] Reg. §1.401(k)-2(b)(3)(iii)(C).

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The regulations impose two additional restrictions on recharacterization of excess contributions. Most importantly, in addition to the above requirements, the excess contributions must be recharacterized no more than 2½ months after the close of the testing year.[662] Amounts are deemed to have been recharacterized as of the date that the last highly compensated employees with recharacterized excess contributions are notified via the appropriate tax forms.[663] In addition, the amount to be recharacterized, together with the amount of employee after-tax contributions actually made, must not exceed any design-based limit imposed by the plan that was in effect as of the first day of the testing year.[664]

6. *Effect of Distribution or Recharacterization of Excess Contributions on Matching Contributions*

If an elective contribution is distributed or recharacterized in order to pass the ADP test, a matching contribution that was made to the plan with respect to the excess contribution must be forfeited or distributed to avoid impermissible discrimination. The test to determine whether each level of match under the plan is available on a nondiscriminatory basis under §401(a)(4) is to be done after any corrective distributions of excess contributions and excess aggregate contributions.[665]

Practice Insight: A match attributable to a distributed excess contribution will need to be forfeited (even if otherwise nonforfeitable) and not distributed. Unless the match is itself an excess aggregate contribution distributable, it may be distributed only to the extent consistent with applicable distribution requirements, and that distribution would not cure any discrimination problem under §401(a)(4).[666] The regulations do make clear that a "qualified matching contribution" will not lose its status as such merely because it is forfeited if the contribution to which it relates is treated as an excess contribution pursuant to a failed ADP test, excess deferral under §402(g), or excess aggregate contribution pursuant to a failed ACP test.[667]

7. *Distribution or Forfeiture of Excess Aggregate Contributions to Correct a Failed ACP Test*

Just as excess contributions created by an ADP test failure may be distributed to enable a CODA to satisfy the ADP test,[668] excess aggregate contributions created by a failed ACP test may be distributed to permit a plan to satisfy the ACP test. In order to be treated as passing the ACP test, the excess aggregate contributions, and any allocable income, must be distributed or, if forfeitable, forfeited before the end of the following plan year.[669] Forfeitures of excess aggregate contributions may not be allocated to other highly compensated participants whose contributions are reduced to correct the failed ACP test.[670] As with any excess contributions under §401(k), the plan must specify the manner in which excess aggregate contributions are to be corrected.[671]

Although corrections must be made no later than 12 months after the close of the plan year in order to maintain qualification,[672] excess aggregate contributions that are not distributed within 2½ months (six months in the case of an eligible automatic contribution arrangement) after the end of the plan year, and are not otherwise corrected, will give rise to the 10% excise tax on the employer under §4979. See III.M.9., below, for a detailed discussion of the §4979 excise tax as it applies to this situation.

The normal vesting rules apparently apply in determining whether matching contributions are forfeitable. In addition, to the extent the excess is attributable to after-tax contributions, elective contributions, or qualified nonelective contributions, no forfeiture would be permitted.[673]

Excess aggregate contributions may not be corrected by forfeiting vested contributions (as opposed to distributing), by distributing nonvested matching contributions (as opposed to forfeiting), by recharacterizing matching contributions (since recharacterized contributions are also subject to the ACP test), or by "not making matching contributions required under the terms of the plan."[674]

Practice Insight: The reason for the last rule, under which employers must make matching contributions that are required under the plan even though it might be known at the time that the contributions will constitute excess aggregate contributions, is unclear. Elsewhere, the regulations also provide that a plan may limit employee or matching contributions in a manner that prevents excess aggregate contributions from being made.[675] In any event, where matching contributions are discretionary, or where a plan specifically provides that an employer may cease to make matching contributions, upon a determination that the plan will fail the ACP test, arguably there are no matching contributions "required under the terms of the plan," and a match that would otherwise be an excess aggregate contribution need not be made. Of course, highly compensated employees would prefer to receive the match as an immediate distribution and pay income tax rather than not have the match made at all.

As with excess contributions under §401(k), distribution of excess aggregate contributions may be made "without regard to any other provision of law,"[676] and without regard to any consent of the participant or spouse that might otherwise be required.[677] In addition, if the distribution is made to a participant before age 59½, the distribution will be exempt from the 10% tax on premature distributions under §72(t).[678] The amount distributed, however, is nonetheless included for purposes of determining the employer's deduction limit under §404 and the participant's annual addition for purposes of the §415 limita-

[662] Reg. §1.401(k)-2(b)(3)(iii)(A).
[663] Reg. §1.401(k)-2(b)(3)(iii)(A).
[664] Reg. §1.401(k)-2(b)(3)(iii)(B).
[665] Reg. §1.401(a)(4)-4(e)(3)(iii)(G).
[666] Reg. §1.401(m)-2(b)(3)(v)(B).
[667] Reg. §1.401(k)-2(b)(4)(iii).
[668] *See* III.M.4., above.
[669] §401(m)(6)(A).
[670] §401(m)(6)(C).
[671] Reg. §1.401(m)-2(b)(2)(v).
[672] Reg. §1.401(m)-2(b)(2)(v).
[673] §411(a)(1), §401(k)(2)(C), §401(m)(4)(C).
[674] Reg. §1.401(m)-2(b)(1)(iii).
[675] Reg. §1.401(m)-2(b)(1)(ii).
[676] §401(m)(6)(A).
[677] Reg. §1.401(m)-2(b)(3)(i).
[678] §401(m)(7)(A).

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tions.[679] Forfeited matching contributions are treated as an annual addition both to the participants to whom they are reallocated and the participants from whom they are forfeited.[680]

Excess aggregate contributions for a plan year may not remain unallocated or be allocated to a suspense account for allocation in any future year.[681] Furthermore, the amount of excess aggregate contributions for any highly compensated employee may not exceed the amount of contributions to the plan that were taken into account for purposes of the ACP on behalf of the employee for that plan year.[682]

Practice Insight: This issue may arise if an HCE is eligible under more than one plan which is aggregated for purposes of the ACP test.

An employer will need to allocate excess aggregate contributions among matching contributions, employee after-tax contributions, elective contributions treated as matching contributions, and QNECs treated as matching contributions where two or more of these contributions are taken into account for purposes of determining the actual contribution ratios. The regulations require that the method of distributing (and, presumably, forfeiting), excess aggregate contributions must satisfy the general nondiscrimination requirements of §401(a)(4).[683] Accordingly, each level of matching contributions must be effectively available to a group that satisfies §410(b) coverage testing.

> *Example:* A profit-sharing plan provides for employee after-tax contributions up to 10% of pay, and provides for a matching contribution equal to 50% of the employee's contributions. No other contributions are provided. The plan may not distribute employee after-tax contributions in an effort to correct excess aggregate contributions while matching contributions attributable to those employee contributions remain allocated to the affected highly compensated employees' accounts, since this would result in an effective rate of matching contributions for those employees in excess of 50%, based on the employee contributions remaining in the plan.

Similarly, in the case of a highly compensated employee who is partially vested in his or her matching contributions, and who has excess aggregate contributions, the nonvested portion of the excess matching contributions should not be forfeited before any distribution of vested matching contributions, because the result would be more rapid vesting of the remaining matching contributions than would be available to the non-highly compensated participants.[684] Permissible approaches would include pro rata distribution (or forfeiture) of vested and nonvested excess matching contributions, or distribution of the vested portion. However, in the latter case, a special vesting provision would be needed to ensure that the nonvested excess match vested as rapidly as if no distribution had been made.[685]

The regulations provide that a method of distributing excess aggregate contributions will not be considered discriminatory solely because, in accordance with the terms of the plan, unmatched employee after-tax contributions that exceed the highest rate at which employee after-tax contributions are matched are distributed before matched employee after-tax contributions, or matching contributions are distributed (or forfeited) before employee contributions.[686]

Neither the statute nor the regulations address how to allocate excess aggregate contributions among elective contributions and qualified nonelective contributions that are taken into account for purposes of the ACP test. One reading of the regulations would be to require that these contributions, like "real" matching contributions, be distributed before any employee after-tax contributions, since they are treated as matching contributions for purposes of the ACP test. On the other hand, elective and qualified nonelective contributions are not taken into account when testing whether a rate of matching contribution is effectively available to a nondiscriminatory group under §401(a)(4). Presumably, the application of the §401(a)(4) nondiscrimination requirements to the method of distributing excess aggregate contributions also has the effect of preventing elective contributions which are taken into account for purposes of the ACP test from being distributed while matching contributions made with respect to those elective contributions remain allocated to the highly compensated employee's account.

A model plan amendment released by the IRS allocates the excess in proportion to the respective amounts of matching contributions and after-tax employee contributions made for the participant for the plan year, as well as any qualified nonelective contributions and elective contributions for the plan year that are taken into account in applying the ACP test.[687] The Bluebook on the 1986 TRA states that a plan is free to designate whether excess aggregate contributions are attributable to elective contributions, qualified nonelective contributions, employee contributions, or matching contributions, "as long as the ordering designated by the plan is used consistently," and as long as the order does not result in impermissible discrimination.[688]

Practice Insight: The principal relevance of allocating excess aggregate contributions between the different contribution types is that any distribution that is attributable to after-tax employee contributions is not included in the participant's gross income (except to the extent attributable to income on those contributions).[689]

8. *Coordination of Excess Contributions, Excess Aggregate Contributions, and Excess Deferrals*

The statute describes the order of determining excess deferrals, excess contributions, and excess aggregate contributions.[690] First, excess deferrals under §402(g) are to be determined and distributed. Second, the excess contributions created by a failed ADP test under §401(k)(8) are to be determined and distributed. Third, the excess aggregate contributions created by a failed ACP test under §401(m)(6) are to be determined

[679] Reg. §1.401(m)-2(b)(3)(ii), §1.415-1(b)(1)(i).
[680] Reg. §1.401(m)-2(b)(3)(ii).
[681] Reg. §1.401(m)-2(b)(1)(iii).
[682] Reg. §1.401(m)-2(b)(2)(iii)(B).
[683] Reg. §1.401(m)-2(b)(3)(v)(B).
[684] Reg. §1.401(m)-2(b)(5).
[685] Reg. §1.401(m)-2(b)(5).
[686] Reg. §1.401(m)-2(b)(3)(v), §1.401(m)-2(b)(5) *Ex.* 7.
[687] *See* Notice 87-2, Model Amendment IV, §12.5. *But see* modifications made by Notice 87-72. *See also* Reg. §1.401(m)-1(e)(2).
[688] 1986 TRA Bluebook at 650.
[689] §401(m)(7)(B).
[690] §401(m)(6)(D).

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and distributed.[691] Note that, whereas many plans will determine and correct excess contributions and excess aggregate contributions within 2½ months after the end of a plan year, excess deferrals under §402(g) are calculated on a calendar year basis only, and may be corrected by distribution to an individual before the following April 15.[692] Thus, unless an excess deferral relates to contributions made to plans maintained by a single employer, the employer may not always be able to correct the §402(g) excess deferral before a §401(k) excess contribution or §401(m) excess aggregate contribution correction.

9. Tax Treatment of Excess Contributions and Excess Aggregate Contributions

A corrective distribution of excess contributions or excess aggregate contributions (and allocable income) is includible in the employee's gross income for the employee's tax year in which it is distributed.[693]

A corrective distribution that is attributable to designated Roth contributions is not includible in income to the extent of the designated Roth contributions.[694] Thus, only the income allocable to designated Roth contributions is taxable. A corrective distribution of a designated Roth contribution cannot be a qualified distribution, even if it otherwise meets the requirements.[695]

Where employee after-tax contributions are being returned, the portion of the distribution representing an investment in the contract under §72 is determined based only on the plan contributions being returned.[696] Thus, if excess aggregate contributions are made up of both employee after-tax and matching contributions, only that portion representing the employee after-tax contribution is considered a return of the investment in the contract, even though the employee has made additional employee after-tax contributions to the plan in the plan year being tested as well as earlier plan years.[697]

For corrective distributions for plan years beginning before January 1, 2008, excess contributions and excess aggregate contributions (and allocable income) that were distributed or recharacterized were taxable to the employee on the earliest dates they would have been received in cash during the plan year had the employee elected cash, unless the distribution is made after 2½ months following the close of the plan year or the total amount of the recipient's excess distributions and excess aggregate distributions, excluding income, was less than $100. In either of the latter cases, the recipient was taxable on the distribution (including income) in the year in which the distribution was made.[698]

As noted above, excess contributions and excess aggregate contributions must be distributed by the end of the following plan year to avoid disqualifying the CODA.[699] In addition, a 10% excise tax applies to excess contributions and excess aggregate contributions and related income that are not distributed within 2½ months after the close of the plan year.[700] The excise tax equals 10% of the sum of the excess contributions,[701] and is imposed on the employer.[702] The excise tax does not apply if qualified nonelective contributions or qualified matching contributions are made within 12 months after the end of the plan year in amounts sufficient to satisfy the ADP or ACP test.[703]

A special rule applies to a CODA that is an eligible automatic contribution arrangement (EACA) (EACAs are discussed in detail in VI., below). Excess contributions under such an arrangement will not be subject to the §4979 excise tax if the contributions and related income are distributed within six months after the close of the plan year.[704] The regulations explicitly provide that all eligible HCEs and Non-HCEs must be covered by the EACA for the entire plan year (or the portion of the year in which the individuals are eligible to participate).[705] As a result, an employer cannot amend its CODA to make it an EACA during the last month of the plan year in order to make the plan eligible for the longer correction period.

Practice Insight: The longer correction period is intended in part to encourage employers to implement EACAs. However, a longer correction period for automatic contribution arrangements is appropriate because it will take longer to complete the ADP test if permissible withdrawals under §414(w) are permitted because these distributions are not counted in determining an employee's actual deferral ratio.[706] Nonetheless, the extended correction period applies to all EACAs, not just arrangements that permit unwind distributions under §414(w). Note, however, that an arrangement must be considered an *eligible* automatic contribution arrangement to qualify for the extended correction period.

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[691] *See* 1986 TRA Conf. Rep., II-396.
[692] *See* VII.E., below.
[693] Reg. §1.401(k)-2(b)(2)(vi)(A), §1.401(m)-2(b)(2)(vi)(A).
[694] Reg. §1.401(k)-2(b)(2)(vi)(C), §1.401(m)-2(b)(2)(vi)(C).
[695] Reg. §1.402A-1, Q&A-2(c).
[696] *See* Reg. §54.4979-1(c)(2).
[697] Reg. §1.401(m)-2(b)(2)(vi).
[698] Reg. §1.401(k)-2(b)(2)(vi)(B), §1.401(m)-2(b)(2)(vi)(B).
[699] §401(k)(8)(A), §401(m)(6)(A).
[700] §4979; Reg. §1.401(k)-2(b)(5)(i), §1.401(k)-2(b)(4)(i).
[701] §4979(a).
[702] §4979(b).
[703] Reg. §54.4979-1(c)(1), §1.401(k)-2(b)(5)(ii), §1.401(k)-2(b)(4)(i).
[704] §4979(f)(1); Reg. §54.4979-1(c).
[705] Reg. §54.4979-1(c).
[706] Reg. §1.401(k)-2(a)(5)(vi).

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IV. Design-Based Safe Harbor Plans

A. *Types of Safe Harbor Plans*

The nondiscrimination tests associated with a qualified CODA are undeniably complex, imposing a variety of administrative burdens on employers and plan service providers, including recordkeeping to monitor employee elections, calculating compliance with the ADP and ACP tests, and correcting any excess contributions and any excess aggregate contributions. This complexity has been widely perceived as discouraging employers, particularly small employers, from maintaining qualified CODAs for the benefit of their employees.

To address this concern, Congress has created a number of design-based safe harbors for §401(k) plans. The fundamental notion in the design-based safe harbors is that the underlying purposes of the nondiscrimination rules — ensuring meaningful retirement savings for rank-and-file employees relative to highly compensated employees — may be satisfied without performing annual ADP and ACP testing if the employer provides a certain level of employer contributions, either in the form of required matching contributions or nonelective contributions, on behalf of all eligible non-highly compensated employees and the CODA meets certain other requirements.

There are five types of safe harbor plan designs:[707]

- §401(k)(12) Safe Harbor Plans — requires a certain level of matching or nonelective contributions;
- §401(k)(13) Safe Harbor Plans — requires a certain level of matching or nonelective contributions and a qualified automatic contribution arrangement (QACA);
- §414(x) Eligible Combined Defined Benefit Plans and Qualified CODAs (DB(k) plans) — requires a certain level of matching contributions (no nonelective contributions), a minimum level of accrued benefits, and an automatic contribution arrangement and is only available for small employers;
- §401(k)(11) SIMPLE Plans — requires a certain level of matching or nonelective contributions and is only available for small employers; and
- §401(k)(16) Starter §401(k) Plans — permits elective deferrals only (no matching or nonelective contributions), requires an automatic contribution arrangement and is only available for employers who have not offered any other type of qualified retirement plan during the tax year.[708]

The specific requirements for each safe harbor are discussed below but generally, each safe harbor requires a specified level of employer-provided contributions or benefits and, in the case of the §401(k)(13) and §414(x) safe harbor plans, an automatic contribution arrangement meeting certain specifications as part of its CODA. The §401(k)(12) and §401(k)(13) safe harbors are available without regard to the size of the plan sponsor. However, the §414(x) safe harbor for DB(k) plans and the SIMPLE §401(k) plan design are only available to employers that do not have more than a specified number of employees.

The benefits of maintaining a safe harbor plan depend on the particular safe harbor but, in general, safe harbor plans are: (i) treated as satisfying the ADP test; (ii) treated as satisfying the ACP test if certain limitations on matching contributions in excess of the required matching contributions are observed and employee after-tax contributions are not permitted; (iii) exempt from the top-heavy requirements of §416 to a certain extent; and (iv) in the case of a DB(k) plan, subject to simplified audit and reporting requirements under ERISA.

The term "design-based safe harbor" is somewhat of a misnomer. One might infer that a plan intended to satisfy the design-based safe harbor requirements may default to the general ADP or ACP tests in the event that one of the safe harbor requirements is not satisfied. However, the IRS takes the position that a failure to satisfy the safe harbor requirements results in disqualification, absent a correction, and that a plan may not simply apply the general ADP or ACP tests.[709] For example, a plan may not contain language stating that it is a safe harbor plan only if the employer decides to provide a safe harbor notice to employees but otherwise will perform the ADP or ACP tests.[710]

B. *Section 401(k)(12) Safe Harbor Plans — Matching or Nonelective Contributions*

As discussed above, the advantages of maintaining a §401(k)(12) safe harbor plan are that the CODA is: (i) treated as satisfying the ADP test; and (ii) treated as satisfying the ACP test if certain limitations on matching contributions are observed and employee after-tax contributions are not permitted.[711] A §401(k)(12) safe harbor plan is also exempt from the top-heavy requirements of §416 for the year if the plan allows only those contributions required to satisfy the safe harbor requirements.[712]

A plan will meet the design-based safe harbor of §401(k)(12) if the CODA satisfies all of the following: (i) the safe harbor contribution requirement;[713] (ii) the withdrawal and vesting requirements;[714] (iii) the notice requirement;[715] and (iv) the plan

[707] At any time during a year, an employer that sponsors a SIMPLE plan may terminate that plan and adopt a safe harbor plan under §401(k)(11), §401(k)(12), §401(k)(13), or §401(k)(16). §408(p)(11), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §332(a), effective for plan years beginning after December 31, 2023. *See* Notice 2024-2, Q&As G-1–7.

[708] Added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §121(a), effective for plan years beginning on or after January 1, 2024.

[709] Reg. §1.401(k)-1(e)(7) and §1.401(m)-1(c)(2), noting that a safe harbor plan may not provide that ADP testing will be used if the requirements of the safe harbor are not satisfied.

[710] IRS Publication 7335, *Employee Benefit Plans — Explanation No. 12 — Section 401(k) Requirements.*

[711] §401(k)(12), added by Small Business Job Protection Act of 1996, Pub. L. No. 104-188, §1433(a), effective for plan years beginning after December 31, 1998, and amended by the SECURE Act of 2019, Pub. L. No. 116-94, Div. O, §103, effective for plan years beginning after December 31, 2019. *See* Notice 2024-2, Q&A J-1 (extending plan amendment deadlines under the SECURE 2.0 Act of 2022); *see also* Notice 2020-86, Q&A-4–13 (interim guidance on changes enacted under §102 and §103 of the SECURE Act), *modified by* Notice 2022-33 (extending plan amendment deadlines provided in Notice 2020-86, Q&A-13).

[712] §416(g)(4), added by EGTRRA, Pub. L. No. 107-16, §613(d), effective for plan years beginning after December 31, 2001.

[713] §401(k)(12)(B) or §401(k)(12)(C).

[714] §401(k)(12)(E).

[715] §401(k)(12)(B).

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year requirement.[716] In addition, a §401(k)(12) safe harbor plan may include optional features, such as a general automatic contribution arrangement (as opposed to a QACA) and the ability to satisfy the safe harbor contribution requirement through another tax-qualified, defined contribution plan.

1. Contribution Requirement

There are two alternative methods of satisfying the safe harbor contribution requirement: safe harbor matching contributions or safe harbor nonelective contributions. A plan may rely on one or the other method from year to year, provided that the plan contains language to such effect and, prior to the beginning of the plan year, specifies which safe harbor contribution method will be used in the safe harbor notice, and satisfies the other annual notice requirements. There are no restrictions in the statute or the regulations that would prohibit a plan from switching between methods from one year to the next year.

a. Safe Harbor Matching Contributions

The safe harbor matching contribution requirement of §401(k)(12) is satisfied if the terms of the plan provide for qualified matching contributions to be made on behalf of each eligible non-highly compensated employee under a "basic matching formula" or an "enhanced matching formula," and the rate of matching contributions is appropriately limited for highly compensated employees, relative to non-highly compensated employees.[717]

(1) Basic Matching Formula

The basic matching formula under §401(k)(12) requires that matching contributions be made on behalf of each eligible non-highly compensated employee equal to 100% of the employee's elective contributions up to 3% of safe harbor compensation, plus 50% of the employee's elective contributions between 3% and 5% of compensation.[718] Thus, the maximum matching contribution required under §401(k)(12) for an employee is equal to 4% of compensation.

Practice Insight: The regulations use the term "safe harbor compensation" but this term merely refers to the definitions of compensation that are permissible under the §401(k)(12) safe harbor, which are discussed below in IV.B.1.c. It does not refer to compensation that falls within the nondiscrimination safe harbor in §414(s).

(2) Enhanced Matching Formula

The enhanced matching formula requires that (1) each eligible non-highly compensated employee receive a matching contribution under a formula that, at any rate of elective contributions, provides an aggregate amount of qualified matching contributions at least equal to the amount that would have been provided under the basic matching formula above; and (2) the rate of the matching contributions do not increase as an employee's rate of elective contributions increases.[719] Thus, for example, a matching contribution formula of 50% of the employee's elective contributions up to 8% of compensation would not qualify as an enhanced matching formula, notwithstanding that it potentially provides the same total matching contribution as the basic formula under §401(k)(12), because an eligible non-HCE would have a lower rate of match than would be provided under the basic formula at any given point below 8%. A common example of a safe harbor enhanced matching formula under §401(k)(12) is 100% of elective contributions up to 4% of compensation.

(3) Required Limitation on Rate of Matching for Highly Compensated Employees

An additional limitation on matching contributions applies both to the basic and enhanced matching formulas. The ratio of matching contributions to elective contributions for a plan year cannot be greater for a highly compensated employee than a non-highly compensated employee who has elective contributions at the same percentage of safe harbor compensation.[720]

Practice Insight: It is common for 401(k) plans to offer the same rate of matching contributions for non-highly compensated employees and highly compensated employees.

(4) Matching After-Tax Contributions

A plan in which safe harbor matching contributions are made may also may provide for matching contributions on both elective contributions and employee after-tax contributions without failing the ADP safe harbor if, under the terms of the plan, safe harbor matching contributions are made: (1) with respect to the sum of an employee's elective and employee after-tax contributions and under the same terms as matching contributions are made with respect to elective contributions; or (2) on elective contributions without being affected by the amount of after-tax employee contributions.[721] However, any after-tax contributions are still subject to the ACP test, as discussed below. As such, an employer may decide not to allow after-tax contributions to be made to a §401(k)(12) safe harbor plan in order to avoid ACP testing, in addition to ADP testing, for the plan year.

> *Example:* A plan will not fail to satisfy the matching contribution requirement merely because the plan provides a required matching contribution equal to 100% of the sum of each eligible employee's elective and after-tax contributions up to 4% of compensation. This is the case even if, during a plan year, an eligible employee first makes employee after-tax contributions of 4% of compensation that are matched by the employer and subsequently makes elective contributions that go unmatched, provided that the same match would have been available if the employee instead had made only elective contributions and no employee after-tax contributions.

(5) Timing of Matching Contributions

A §401(k)(12) safe harbor plan may provide that safe harbor matching contributions will be made separately with re-

[716] Reg. §1.401(k)-3, as amended by T.D. 9875, 84 Fed. Reg. 49,651 (Sept. 23, 2019), applicable to distributions made on or after January 1, 2020, with option for earlier applicability date.

[717] §401(k)(12)(B).

[718] Reg. §1.401(k)-3(b)(2).

[719] Reg. §1.401(k)-3(c)(3).

[720] Reg. §1.401(k)-3(c)(4).

[721] Reg. §1.401(k)-3(c)(5)(i).

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spect to each payroll period (or with respect to all payroll periods ending with or within each month or quarter of the plan year), as long as the matching contributions are contributed by the last day of the immediately following plan year quarter.[722]

(6) Permissible Restrictions on Elective Contributions by Non-Highly Compensated Employees

For plans that rely on safe harbor matching contributions, elective contributions by non-highly compensated employees may not be restricted, except in the following circumstances:[723]

- A plan may limit the frequency and duration of periods in which eligible employees may make or change cash or deferred elections, provided that an employee has a reasonable opportunity (including a reasonable period after receipt of the safe harbor notice described below) to make or change a cash or deferred election for the plan year.[724] For this purpose, the regulations deem a period of 30 days to be reasonable.

- A plan is permitted to limit the amount of elective contributions that may be made by an eligible employee provided that each eligible non-highly compensated employee is permitted 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 (unless the employee is restricted under other limitations of the Code, as discussed in the final bullet below) and the employee is permitted to elect any lesser amount of elective contributions.[725]

- A plan may require eligible employees to make cash or deferred elections in whole percentages of compensation or whole dollar amounts.[726]

- A plan may limit the types of compensation that may be deferred by an eligible employee, provided that each eligible non-highly compensated employee is permitted to make elective contributions based on a definition of compensation that would be reasonable within the meaning of Reg. §1.414(s)-1(d)(2) but need not satisfy the nondiscrimination requirement of Reg. §1.414(s)-1(d)(3).[727]

- A plan may also limit the amount of elective contributions made by an eligible employee in order to satisfy the limitations under §402(g) or §415 or due to a suspension of elective contributions due to hardship distributions made before January 1, 2020.[728]

b. Nonelective Contributions

In lieu of satisfying the safe harbor matching contribution requirements discussed above, an employer may make qualifying nonelective contributions on behalf of each non-highly compensated eligible employee equal to at least 3% of the employee's "safe harbor compensation," without regard to whether the employee makes elective contributions.[729] Thus, plans that rely on safe harbor nonelective contributions are not subject to the special rules relating to elective deferrals that otherwise apply to plans that rely on safe harbor matching contributions, such as the reasonable election periods for making deferrals, the minimum amounts of elective contributions that must be allowed, or the types of compensation that may be deferred. For plan years beginning after 2019, a plan may be amended to add required nonelective contributions after the beginning of a plan year when the amendment is adopted either (1) no later than the 30th day before the end of the plan year; or (2) at any time before the last day by which excess contributions must be distributed for that plan year. Further, such an amendment will meet the safe harbor requirements where the minimum nonelective contribution established is at least 4% of the employee's compensation. If, however, a plan provided for matching contributions at any time during the plan year, this exception will not apply.[730]

c. Definition of Compensation

For purposes of determining the amount of safe harbor matching or nonelective contributions, a §401(k)(12) safe harbor plan must use a nondiscriminatory definition of compensation under §414(s) and Reg. §1.414(s)-1, except that the rule in the last sentence of Reg. §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 non-highly compensated employees.[731] For example, the definition of compensation that is used to measure safe harbor employer contributions may exclude bonuses, commissions, overtime, and other items of compensation provided that the definition of compensation does not by design favor highly compensated employees (HCEs), is reasonable within the meaning of Reg. §1.414(s)-1(d)(2), and satisfies the nondiscrimination requirements of Reg. §1.414(s)-1(d)(3).

For purposes of elective deferrals, a §401(k)(12) safe harbor plan must permit each eligible non-highly compensated employee 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), which means that the definition is not required to satisfy the nondiscrimination requirement of Reg. §1.414(s)-1(d)(3). As such, a §401(k)(12) safe harbor plan may limit the types of compensation that may be deferred by an eligible employee, such as permitting elective deferrals to be made only from an employee's base salary, even if this definition did not satisfy the nondiscrimination requirements of Reg. §1.414(s)-1(d)(3) (and, therefore, could not be used as the definition of compensation for safe harbor contribution purposes), provided that the definition used

[722] Reg. §1.401(k)-3(c)(5)(ii).
[723] Reg. §1.401(k)-3(c)(6)(i).
[724] Reg. §1.401(k)-3(c)(6)(ii).
[725] Reg. §1.401(k)-3(c)(6)(iii).
[726] Reg. §1.401(k)-3(c)(6)(iii).
[727] Reg. §1.401(k)-3(6)(iv).
[728] Reg. §1.401(k)-3(c)(6)(v).

[729] §401(k)(12)(C); Reg. §1.401(k)-3(b).
[730] §401(k)(12)(F), added by Pub. L. No. 116-94, Div. O, §103(b), effective for plan years beginning after December 31, 2019 (also redesignating former §401(k)(12)(F) as §401(k)(12)(G)). *See* Notice 2024-2, Q&A J-1 (extending plan amendment deadlines under the SECURE 2.0 Act of 2022); *see also* Notice 2020-86, Q&A-8–13, *modified by* Notice 2022-33 (extending plan amendment deadlines provided in Notice 2020-86, Q&A-13).
[731] Reg. §1.401(k)-3(b)(2).

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for deferral purposes is a reasonable definition of compensation within the meaning of Reg. §1.414(s)-1(d)(2).[732]

Practice Insight: Although a §401(k)(12) safe harbor plan has the flexibility to use a definition of compensation for safe harbor contribution purposes that is different from the definition used for purposes of elective deferrals, many plans use the same definition of compensation for both purposes, in order to simplify employee communications and plan administration.

d. Special Rules Applicable to Safe Harbor Matching and Nonelective Contributions

In addition to the basic formulas, limitations, and restrictions discussed above that must be observed in order for employer contributions to be treated as safe harbor matching or nonelective contributions, there are additional rules that apply when taking such contributions into account under the §401(k)(12) safe harbor. Each of these is discussed below.

(1) Contributions Taken into Account for ADP Testing Purposes for Plan Year

A safe harbor matching or a nonelective contribution is taken into account for purposes of the safe harbor for a plan year only if the contribution would be taken into account for that plan year under the ADP testing rules, as if the ADP test were to be applied.[733] Thus, for example, a safe harbor matching or nonelective contribution must be made within 12 months of the end of the plan year. Also, an elective contribution that would have been received by the employee within 2½ months after the close of the year, but is nonetheless taken into account under the plan for that year because it is attributable to performance of services in that year, will be taken into account in applying the safe harbors.[734]

(2) Satisfying the Safe Harbor Contribution Requirement Under Another Plan

The safe harbor matching or nonelective contribution requirements can be satisfied by another defined contribution plan of the employer, as they need not be satisfied by the same plan that includes the CODA.[735] If safe harbor contributions are made to another defined contribution plan, the safe harbor plan must specify the plan to which the safe harbor contributions are made, and the safe harbor contribution requirement must be satisfied in the same manner as if the contributions were made to the plan that contains the CODA.[736] Consequently, the plan to which the contributions are made must have the same plan year as the plan containing the CODA.[737] In addition, each employee eligible under the plan containing the CODA must be eligible under the same conditions under the other defined contribution plan.[738] 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 CODA.[739]

However, safe harbor matching or nonelective contributions cannot be used to satisfy the requirements of the safe harbors with respect to more than one plan.[740] In other words, safe harbor contributions may only be taken into account once for ADP testing purposes.

(3) Aggregation and Disaggregation of Plans

In general, all CODAs included in a plan are treated as a single CODA that must satisfy the safe harbor contribution and the notice requirements.[741] Moreover, if an employer chooses to aggregate two plans for purposes of §410(b) coverage testing, those two plans are treated as a single plan for purposes of the safe harbor methods.[742] See III.C., above, for a detailed discussion of the aggregation rules of Reg. §1.410(b)-7(d) and exceptions to such rules for §401(k) plans.

Practice Insight: One of the most common disaggregation rules that applies is that a plan that includes a CODA covering both collectively bargained employees and noncollectively bargained employees is treated as two separate plans for purposes of §401(k), and the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor.[743]

As described in III.C., above, if pursuant to §410(b)(4)(B), an employer applies §410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions permitted under §410(a), the plan is treated as two separate plans for purposes of §401(k), and the ADP test safe harbor need not be satisfied with respect to both plans in order for one of the plans to take advantage of the ADP test safe harbor.[744] Thus, a plan that uses one of the §401(k) safe harbor methods is not required to provide safe harbor matching or nonelective contributions to participants who have not yet attained age 21 and completed a year of service. Those employees do not have to be treated as eligible employees for purposes of the §401(k) safe harbors, as long as the employer has elected to treat them separately for coverage purposes pursuant to §410(b)(4). However, in such a case, the plan must specifically provide that elective contributions (and, if applicable, matching contributions) on behalf of those employees will satisfy the ADP test (and, if applicable, the ACP test). The special rule of §401(k)(3)(F), under which eligible employees (other than highly compensated employees) who have not completed the minimum age and service requirements of §410(a)(1)(A) are disregarded in applying the ADP test does not apply to the safe harbors. The requirements of the safe harbors must be satisfied with respect to these eligible employees to the extent these employees are part of a component plan that is a safe harbor plan.[745]

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[732] Reg. §1.401(k)-3(b)(1), §1.401(k)-3(b)(2).

[733] Reg. §1.401(k)-3(h)(1).

[734] Reg. §1.401(k)-3(h)(1). See III.L., above, for a discussion regarding when matching and nonelective contributions can be taken into account for purposes of the ADP test.

[735] Reg. §1.401(k)-3(h)(4).

[736] Reg. §1.401(k)-3(h)(4).

[737] Reg. §1.401(k)-3(h)(4).

[738] Reg. §1.401(k)-3(h)(4).

[739] Reg. §1.401(k)-3(h)(4).

[740] Reg. §1.401(k)-3(h)(5).

[741] Reg. §1.401(k)-1(b)(4)(ii).

[742] Reg. §1.401(k)-1(b)(4)(iii).

[743] Reg. §1.401(k)-1(b)(4)(v).

[744] Reg. §1.401(k)-1(b)(4)(iv). *See also* Notice 2000-3, Q&A-10.

[745] Notice 2000-3, Q&A-10.

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Similarly, different levels of qualified matching contributions cannot be provided to different classes of employees under a CODA that is part of a single component plan.[746] The same qualified formula must be used for all eligible Non-HCEs. As a result, for example, the basic formula cannot be used for one division of an employer under a plan while an enhanced formula is used for another division under the same plan. It is possible, however, to establish two different plans to accomplish the same goal.

e. Effect of Additional Nonelective or Matching Contributions and After-Tax Employee Contributions

A §401(k)(12) safe harbor plan must satisfy the contribution requirements discussed above. However, a §401(k)(12) safe harbor plan may provide for additional contributions above and beyond the safe harbor contributions. In general, these contributions are treated in the same manner as contributions to a non-safe harbor plan. Thus, the contributions must satisfy the minimum coverage test in §410(b) and the general nondiscrimination tests of §401(a)(4). In addition, these contributions are not subject to the vesting and withdrawal requirements that apply to safe harbor contributions. As a result, for example, a §401(k)(12) safe harbor plan may include additional nonelective employer contributions that are subject to a vesting schedule and amounts attributable to these contributions are not subject to the restrictive in-service distribution rules that apply to safe harbor nonelective employer contributions.

There are, however, a number of special considerations for a §401(k)(12) safe harbor plan that includes additional contribution features.

(1) Additional Matching Contributions — ACP Safe Harbor for §401(k)(12) Plans

Matching contributions are generally subject to the ACP test, but a safe harbor plan that uses the matching contribution alternative to satisfy the §401(k)(12) safe harbor, and does not provide for any other matching contributions, is automatically treated as satisfying the ACP test.[747] However, it is possible for an employer to provide additional matching contributions, i.e., a more generous matching contribution formula, and to continue to be treated as automatically satisfying the ACP test, if the additional matching contributions comply with the following limitations.

First, matching contributions may not be made with respect to an employee's contributions or elective deferrals in excess of 6% of the employee's compensation.[748] Second, matching contributions that are discretionary may not exceed 4% of the employee's compensation.[749] Third, the rate of matching contribution may not increase as the rate of employee contributions or elective deferrals increases.[750] Fourth, at any rate of employee contribution or elective deferral, the matching contribution with respect to a highly compensated employee may not be greater than the matching contribution with respect to a non-highly compensated employee.[751] A plan does not fail to satisfy this last requirement merely because it 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, so long as the matching contributions for any quarter are contributed to the plan by the last day of the following quarter.

In applying the fourth limitation above, matching contributions for a highly compensated employee under all plans of the employer will be taken into account. However, non-simultaneous participation in more than one plan during a year, or the period used to determine compensation under each plan is limited to periods of actual participation in the plan, will not result in failure to satisfy the safe harbor matching contribution requirements.[752]

If the matching contributions made to the §401(k)(12) safe harbor plan exceed these limits, then the ACP test must be applied.

(2) Additional Nonelective Employer Contributions

As mentioned above, additional employer contributions are subject to the general nondiscrimination requirements of §401(a)(4). In meeting these requirements, the safe harbor nonelective contributions made to the plan may be taken into account. In this regard, nonelective contributions used to satisfy the design-based safe harbor can be used to satisfy other qualified retirement plan nondiscrimination rules as well.[753] However, these contributions cannot be taken into account in determining whether a plan meets the permitted disparity rules of §401(l).[754]

(3) After-Tax Employee Contributions

The designed-based safe harbors provide relief from ACP testing only for matching contributions, and do not provide relief for after-tax employee contributions. After-tax employee contributions continue to be subject to ACP testing.[755] Moreover, employer matching and nonelective contributions used to satisfy the safe harbor requirements cannot be considered in applying the ACP test, except to the extent they exceed the amounts required to satisfy the safe harbor requirements.[756]

Practice Insight: It would be unusual for a §401(k)(12) safe harbor plan to include after-tax employee contributions for this reason. The after-tax employee contributions would not be tested separately from matching contributions. Rather, the plan would be subject to the full ACP test, which would undermine the relief in §401(k)(12).

Practice Insight: Interestingly, the design-based safe harbor provisions in §401(m)(11) refer to the contribution and notice requirements in subparagraphs (B), (C), and (D) of §401(k)(12), which sets forth the design-based safe harbors from ADP testing. No reference is made to §401(k)(12)(E), which includes a full vesting requirement, imposition of the distribution restrictions of §401(k)(2)(B), and restrictions with regard to

[746] Reg. §1.401(k)-3(c)(7) *Ex.* 5.
[747] §401(m)(11).
[748] Reg. §1.401(m)-3(d)(3)(i).
[749] Reg. §1.401(m)-3(d)(3)(ii).
[750] Reg. §1.401(m)-3(d)(2).
[751] Reg. §1.401(m)-3(d)(4).
[752] Reg. §1.401(m)-3(d)(5).
[753] Reg. §1.401(k)-3(h)(2); 1996 TRA Bluebook at 153.
[754] §401(k)(12)(E)(ii); Reg. §1.401(k)-3(h)(2).
[755] Notice 98-52, §III.F.
[756] 1996 Bluebook, at 153.

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permitted disparity under §414(l), or §401(k)(12)(F), which permits the design-based safe harbor requirements to be satisfied by another plan of the employer. However, subparagraphs §401(k)(12)(E) and §401(k)(12)(F), by their terms, modify §401(k)(12)(B) and §401(k)(12)(C). Therefore, they presumably apply as well in determining whether the ACP design-based safe harbors in §401(m)(11) are satisfied.

2. Withdrawal, Vesting, and Other Restrictions

A §401(k)(12) safe harbor plan must provide that all safe harbor employer contributions, including safe harbor matching contributions, are fully vested and nonforfeitable.

In addition to vesting limitations, safe harbor plans may not condition contributions on certain requirements. A plan may not require that an employee be employed on the last day of the plan year in order to receive a safe harbor matching or nonelective contribution and may not condition the match or nonelective contribution upon completion of a certain number of hours of service, e.g., 1,000 hours of service in the plan year.[757] These conditions are impermissible because they could result in contributions not being made on behalf of all non-highly compensated employees, such as in the case of a non-highly compensated employee who terminates employment during the year.

In addition, a safe harbor plan must impose the same withdrawal restrictions that apply to elective deferrals under a §401(k) plan to employer safe harbor contributions. As a result, for example, safe harbor employer contributions may not be distributable prior to the permitted distributable events in §401(k)(2)(B) and, if applicable, §414(w).

3. Notice Requirement

To satisfy the §401(k)(12) safe harbor, each employee eligible to participate in the CODA must, within a reasonable period before any year, be given written notice of the employee's rights and obligations under the CODA in a manner that is sufficiently accurate and comprehensive to apprise the employee of his or her rights and obligations under the plan, and written in a manner calculated to be understood by the average eligible employee.[758] This is sometimes referred to as the "mini-SPD requirement."

For plan years beginning after December 31, 2019, the SECURE Act eliminated the safe harbor notice requirement for §401(k)(12) plans that use nonelective contributions but not for plans that use matching contributions.[759] Presumably, the notice requirement continues to apply to §401(k)(12) plans that use nonelective contributions to satisfy the ADP safe harbor but also provide for matching contributions, as the SECURE Act did not amend the notice requirements as they relate to the ACP safe harbor of §401(m)(11).[760] Employees are still required to be able to make or change an election at least once per year, even if no safe harbor notice is required.

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

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

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

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

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

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

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

(7) withdrawal and vesting provisions applicable to contributions under the plan; and

(8) information that makes it easy to obtain initial information about the plan (including an additional copy of the summary plan description) such as telephone numbers, addresses, or electronic addresses.[761]

A plan will not fail the notice content requirement if the notice cross-references relevant and up-to-date portions of a summary plan description that has been provided (or concurrently is provided) to the employee. However, the notice still must include the information described in (1), (5), (6), (7), and (8), above.[762]

A notice is treated as satisfying the reasonable time requirement 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 (or, if later, within the 90-day period ending with the day the employee becomes eligible).[763] However, the general rule is that the notice must be provided within a reasonable period before the beginning of the plan year (or, in the year the employee becomes eligible, within a reasonable period before the employee becomes eligible), which is determined based on all the facts and circumstances.

Practice Insight: It is sometimes not practicable to provide the notice before the date an employee first becomes eligible to participate, as in the case of a new hire in a plan that provides for immediate eligibility, for example. The regulations provide that the notice will nonetheless be timely if it is provided as soon as practicable after that date, but no later than the first payroll date in which an election to defer may be effective, and the employee is permitted to elect to defer from all types of compensation that may be deferred under the plan earned beginning on the date the employee becomes eligible.[764]

The required notice may be provided in writing or in electronic form, provided that the general IRS requirements for paperless delivery of notices in Reg. §1.401(a)-21 are satisfied.[765]

[757] Reg. §1.401(k)-3(c)(7) *Ex.* 4.

[758] §401(k)(12)(D); Reg. §1.401(k)-3(d)(2)(i).

[759] §401(k)(12)(A)(ii), as amended by Pub. L. No. 116-94, Div. O, §103(a)(1).

[760] §401(m)(11)(A)(ii).

[761] Reg. §1.401(k)-3(d)(2)(ii).

[762] Reg. §1.401(k)-3(d)(2)(iii).

[763] Reg. §1.401(k)-3(d)(3)(ii).

[764] Reg. §1.401(k)-3(d)(3)(ii).

[765] Reg. §1.401(k)-3(d)(1).

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If an employer fails to provide notice, the correction depends on the failure's effect on particular participants. If the failure results in an employee's inability to make elective deferrals, the IRS may require the employer to make a corrective contribution. However, if the employee was otherwise informed that she could make elective deferrals, the IRS may only require the employer to revise its notice procedures.[766]

> *Example:* Company C sponsors a §401(k) safe harbor plan. C fails to provide the safe harbor notice required by §401(k)(12) to a newly eligible employee W. If C in no other way informed W of her right to make an elective contribution, C would have to make a corrective contribution to replace W's missed deferral opportunity and matching contributions. If C instead had informed W of her right to make an elective contribution other than through a safe harbor notice (for example, C's human resources department informed W of the right), C would not have to make a corrective contribution. The IRS would, however, require C to change its procedures to ensure that employees received timely notice in the future.

4. Plan Year Requirement

Regulations provide that, as a general rule, a plan will not satisfy the §401(k)(12) safe harbor requirements unless the plan is adopted with, or amended to contain, the required safe harbor provisions before the first day of the plan year and such provisions remain in effect for the entire 12-month plan year.[767] The regulations go so far as to provide that a plan will not satisfy the safe harbor requirements if it is amended during the year.[768] However, certain midyear changes are permissible under IRS guidance, and will not violate the safe harbor rules merely because they are not in place for the 12-month plan year, as long as the changes are not prohibited by the IRS guidance and the notice and election opportunity conditions are satisfied.[769]

The IRS's guidance on mid-year changes pertains to a change that is first effective during a plan year but not effective as of the beginning of that year or to a change that is adopted after the beginning of the plan year but is effective as of the beginning of that year.[770] When a mid-year change is being made and that change affects required safe harbor notice content, each employee who is required to be provided with a safe harbor notice, as discussed in IV.B.3., above, must be provided with an updated notice that describes the mid-year change and its effective date. The updated notice must be provided within a reasonable period before the effective date of the change, as determined based on all the relevant facts and circumstances. The timing requirement is deemed to be met if the updated safe harbor notice is provided at least 30 days and not more than 90 days before the effective date of the change or, if it is not practicable for the updated notice to be provided before the effective date of the change, as soon as practicable but not later than 30 days after the date the change is adopted. The updated notice is not required if the required information was provided with the pre-plan year annual safe harbor notice. Employees who are required to be provided with an updated safe harbor notice must be given a reasonable opportunity before the effective date of the mid-year change, generally 30 days, to change their cash or deferred election and any after-tax employee contribution election. If it is not practicable for the election opportunity to be provided before the effective date of the change, the election opportunity must begin as soon as practicable but no later than 30 days after the date the change is adopted.[771]

A mid-year change that relates to adoption of a short plan year or any change to the plan year, adoption of safe harbor plan status, or reduction or suspension of safe harbor contributions, or changes from safe harbor plan status to non-safe harbor plan status, must instead satisfy the applicable safe harbor provisions of Reg. §1.401(k)-3 (or Reg. §1.401(m)-3), discussed below.[772] In addition, the IRS guidance allowing mid-year changes to safe harbor plans and required notices does not apply to a mid-year change that is prohibited by IRS guidance. A mid-year change is prohibited if it is:[773]

- to increase the number of completed years of service required for an employee to have a nonforfeitable right to the employee's account balance attributable to safe harbor contributions under a qualified automatic contribution arrangement (QACA), discussed in IV.C., above;
- to reduce the number or narrow the group of employees eligible to receive safe harbor contributions, unless the change is otherwise permissible under eligibility service crediting rules or entry date rules made for employees who are not already eligible to receive safe harbor contributions under the plan;
- to the design or type of safe harbor plan (e.g., changing from a traditional §401(k) safe harbor plan to a QACA §401(k) safe harbor plan); or
- to add or modify a formula used to determine matching contributions (or the definition of compensation for this purpose) if the change increases the amount of matching contributions, or to permit discretionary matching contributions; except that the prohibition does not apply if, at least three months before the end of the plan year, the change is adopted and the updated safe harbor notice and election opportunity are provided, and if the change is made retroactively effective for the entire plan year.

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[766] *See* IRS, "Fixing Common Plan Mistakes — Failure to Provide a Safe Harbor 401(k) Plan Notice," http://www.irs.gov/Retirement-Plans/Fixing-Common-Plan-Mistakes-Failure-to-Provide-a-Safe-Harbor-401k-Plan-Notice.

[767] Reg. §1.401(k)-3(e)(1).

[768] Reg. §1.401(k)-3(e)(1).

[769] Notice 2020-52. Plan amendments that reduce or suspend safe harbor nonelective contributions will not violate safe harbor requirements of Reg. § 1.401(k)-3(g)(1)(ii) or Reg. §1.401(m)-3(h)(1)(ii) because supplemental notice of the plan amendment is not provided to employees at least 30 days prior to the effective date of the reduction or suspension, so long as an employer provides the supplemental notice to all eligible employees no later than August 31, 2020, and the amendment is adopted no later than the effective date of the reduction or suspension of the nonelective safe harbor contributions.

[770] Notice 2016-16, §III.A.

[771] Notice 2016-16, §III.C.

[772] Notice 2016-16, §III.B. The IRS noted that whether a mid-year change is permissible also may depend on other laws, such as anti-cutback restrictions under §411(d)(6), nondiscrimination restrictions under §401(a)(4), and anti-abuse provisions under Reg. §1.401(k)-1(b)(3).

[773] Notice 2016-16, §III.D.

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If safe harbor matching or nonelective contributions are to be made under another plan for the plan year, the relevant provisions of that other plan must also be adopted before the first day of the plan year unless the IRS guidance permits a mid-year change.

The regulation's safe harbor provisions provide that a newly established plan (other than a successor plan) may have an initial plan year of less than 12 months (provided it is at least three months long, or the employer is itself newly established and establishes the plan as soon as administratively feasible).[774] Similarly, a CODA may be added to an existing profit-sharing, stock bonus, or pre-ERISA money purchase pension plan for the first time during a plan year, so long as it is made effective at least three months before the end of the plan year.[775] A short plan year that results from a change in plan year is also not a problem, if the safe harbor requirements are satisfied for the 12-month plan years before and after the short year.[776]

A plan that terminates during a plan year may have a final plan year of less than 12 months, as long as the safe harbor requirements are met through the date termination, the termination is either in connection with a §410(b)(6)(C) transaction or results from a substantial business hardship similar to those described in §412(c) and the conditions that apply to a suspension of safe harbor matching contributions are met.[777]

a. *Permitted Suspension or Reduction of Safe Harbor Contributions*

A plan may generally be amended only prospectively each plan year with respect to the safe harbor provisions. Thus, a plan may be a safe harbor plan for one year and a non-safe harbor plan for another year, or rely on a different safe harbor contribution method from year to year. However, a plan may be amended during a plan year to reduce or entirely suspend safe harbor contributions only if certain conditions are satisfied.[778] This is an exception to the requirement that a safe harbor plan generally be in effect for the entire 12-month plan year.

Safe harbor matching or nonelective contributions may only be reduced or suspended midyear if either of the following circumstances exists: (1) the employer is operating at an "economic loss" for the plan year; or (2) the safe harbor notice provided at the beginning of the plan year includes a statement that the plan may be amended during the plan year to reduce or suspend safe harbor matching contributions and that the reduction or suspension will not apply until at least 30 days after all eligible employees are provided a supplemental notice of the reduction or suspension.[779]

The IRS provided temporary relief in connection with the COVID-19 pandemic from these two requirements for midyear amendments adopted between March 13, 2020, and August 31, 2020, that reduce or suspend safe harbor contributions.[780]

Previously, the rules on midyear reductions and suspensions of safe harbor contributions were less strict and did not require that either of these conditions exist. These conditions became applicable on November 15, 2013, for nonelective contributions, and effective for plan years beginning before January 1, 2015, for matching contributions. As such, the midyear change could be made in the absence of an economic loss or the suspension language being included in the existing safe harbor notice, so long as certain other requirements, similar to those discussed below in bullets, were satisfied.

Practice Insight: Plan sponsors should consider adding a statement to the annual safe harbor notice indicating that the plan may be amended during the plan year to reduce or suspend safe harbor matching contributions as a protective measure against having to establish that the employer is operating at an economic loss. This provides plan sponsors with the flexibility to change the safe harbor matching contributions on a midyear basis for any reason, even if the plan sponsor does not anticipate having to change safe harbor contributions during the plan year.

If either of the two conditions exists (i.e., economic loss or the suspension language being included in the existing safe harbor notice), a plan may be amended midyear, on prospective basis only, to reduce or suspend future safe harbor matching contributions, provided that the plan sponsor complies with the following requirements of the regulations:

- All eligible employees are provided a supplemental notice (in writing or such other form as prescribed by the IRS) that explains the consequences of the amendment that reduces or suspends future safe harbor contributions, the procedures for changing their cash or deferred elections and, if applicable, their employee contribution elections and the effective date of the amendment;

[774] Reg. §1.401(k)-3(e)(2).

[775] Reg. §1.401(k)-3(e)(2).

[776] Reg. §1.401(k)-3(e)(3).

[777] Reg. §1.401(k)-3(e)(4). The following conditions for suspension of safe harbor matching contributions are not required for this purpose: the requirements regarding the employer's financial condition or the additional information included in the initial notice for the plan year; and the requirement that employees have a reasonable opportunity to change their cash or deferred elections. Reg. §1.401(k)-3(e)(4)(i).

[778] Reg. §1.401(k)-3(g). *See* Notice 2020-52, §III, *clarifying* Notice 2016-16, §III.B. The IRS also may issue guidance indicating additional situations in which a plan that includes provisions satisfying the safe harbor requirements of Reg. §1.401(k)-3 may be amended during the plan year to implement a mid-year change. Reg. §1.401(k)-3(e)(1). Prior to the issuance of the regulations permitting suspension of safe harbor nonelective contributions, the only way to suspend safe harbor nonelective contributions during the plan year was to terminate the plan, which involved not only discontinuing future contributions but also timely distributions of all of the plan's assets. Thus, an employer faced with an unexpected financial hardship had to make the difficult choice between terminating its safe harbor nonelective contribution plan completely or continuing to make safe harbor nonelective contributions that might not be affordable. Before May 18, 2009, the regulations only permitted the suspension of safe harbor matching contributions, but subsequent regulations permitted the suspension of safe harbor nonelective contributions for amendments adopted after May 18, 2009. T.D. 9641, 78 Fed. Reg. 68,735 (Nov. 15, 2013).

[779] Reg. §1.401(k)-3(g)(1)(i)(A). The regulations refer to §412(c)(2)(A) for the meaning of the term "economic loss," which is merely one of the factors in §412(c)(2) that the IRS uses to determine whether to grant a waiver of the minimum funding requirement for a defined benefit plan. Notably, the preamble to the safe harbor regulations specifically states that the three other factors in §412(c)(2), which would require taking into account the health of the industry and whether the reduction or suspension of contributions is needed so that the plan will continue, do not apply for purposes of the reduction or suspension of safe harbor contributions. T.D. 9641. Unlike a funding waiver, a plan sponsor does not need to obtain IRS approval to reduce or suspend safe harbor matching contributions on the basis of operating at an economic loss, but the plan sponsor should be prepared to defend its satisfaction of the requirements on audit.

[780] Notice 2020-52.

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- The reduction or suspension of safe harbor matching contributions is effective no earlier than the later of the date the amendment is adopted or 30 days after eligible employees are provided the supplemental notice;

- 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;

- 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 ADP testing method of Reg. §1.401(k)-2(a)(2)(ii); and

- The plan continues to satisfy the §401(k)(12) safe harbor requirements with respect to amounts deferred through the effective date of the amendment.[781]

For plan years beginning after December 31, 2019, the SECURE Act eliminated the safe harbor notice requirement for nonelective safe harbor plans.[782] As such, plan sponsors may switch to a safe harbor 401(k) plan with nonelective contributions prior to the 30th day before the end of the plan year. Alternatively, if the amendment provides for a nonelective contribution of 4% (instead of 3% of compensation) for the plan year, the amendment may be made any time prior to the last day of the following plan year.[783]

Under the IRS's temporary relief in connection with the COVID-19 pandemic, if a plan amendment that reduces or suspends safe harbor nonelective contributions during a plan year is adopted between March 13, 2020, and August 31, 2020, then the plan will not be treated as failing to satisfy the safe harbor nonelective contributions requirements merely because a supplemental notice is not provided to eligible employees at least 30 days before the reduction or suspension of safe harbor nonelective contributions is effective, provided that (1) the supplemental notice is provided to eligible employees no later than August 31, 2020; and (2) the plan amendment that reduces or suspends safe harbor nonelective contributions is adopted no later than the effective date of the reduction or suspension of safe harbor nonelective contributions.[784] For plans that are amended to reduce or suspend safe harbor matching contributions, however, the IRS did not change the supplemental notice requirements. As such, a supplemental notice must still be provided to the plan participants 30 days prior to the effective date of the amendment.

Practice Insight: The SECURE Act's removal of the annual safe harbor notice requirements for a plan with nonelective contributions does not appear to have affected the requirement that a supplemental notice (as described in the first bullet point above) be provided if such a plan makes a mid-year change to the nonelective contributions. Although there is no guidance that directly addresses the issue, the fact that the temporary COVID-19 relief provided in Notice 2020-52 modifies the timing requirements for providing a supplemental notice when a plan makes a mid-year change to the nonelective safe harbor contributions suggests that the IRS views the supplemental notice requirement as applicable in light of the SECURE Act.

There are material consequences associated with a mid-year suspension. Most notably, the plan will lose its safe harbor status for the entire plan year, including the portion in which the rules were satisfied, and will need to satisfy the ADP and ACP tests, as applicable. A plan that is relying on the exemption from the top-heavy rules under §416(g)(4)(H) will also lose the relief, since the plan will no longer be considered a safe harbor plan. Further, it appears that a plan that suspends its safe harbor contributions would need to prorate the otherwise applicable compensation limit under §401(a)(17).[785] Proration of the §401(a)(17) compensation limit effectively prevents a very highly paid employee from obtaining the maximum safe harbor contribution during the period in which contributions were not suspended. It is not entirely clear how this would apply where employer contributions are reduced, rather than eliminated, but presumably the same proration principles would apply.

b. "Wait-and-See" Safe Harbor

Special rules apply to plan sponsors that may want to rely on nonelective contributions to satisfy the §401(k)(12) safe harbor. These rules, which are sometimes referred to as the "wait-and-see" approach, provide additional time to adopt amendments to implement safe harbor nonelective contributions for a plan year and avoid ADP testing. Under this approach, a plan sponsor can amend the plan after the first day of the plan year but not later than: (1) 30 days before the last day of the plan year to adopt a 3% nonelective contribution safe harbor; and (2) the last day for distributing excess contributions for the plan year (i.e., the last day of the following plan year) to adopt a nonelective contribution of at least 4% of compensation (instead of 3%). This is another exception to the requirement that a safe harbor plan generally be in effect for the entire 12-month plan year, but it applies only to nonelective safe harbor contributions and cannot be utilized for safe harbor matching contributions.

Practice Insight: The rationale for allowing extra time to decide whether to adopt nonelective safe harbor contributions, but not safe harbor matching contributions, is that nonelective contributions are made by the employer without regard to the employees' elective deferrals. As such, employees need to be made aware of the level of safe harbor matching contributions that the employer will be required to make for the plan year in order for the employees to choose the appropriate amount of elective deferrals and have an adequate opportunity to maximize the matching contributions received for the plan year.

For plan years beginning prior to January 1, 2020, the wait-and-see approach did not permit amendments to implement nonelective safe harbor contributions to be adopted any later than 30 days before the end of the plan year (i.e., option (2) above was not available) and required that the annual notice with wait-and-see language and follow-up notices be provid-

[781] Reg. §1.401(k)-3(g)(1)(i).

[782] §401(k)(12)(A)(ii), as amended by Pub. L. No. 116-94, Div. O, §103(a)(1).

[783] §401(k)(12)(F)(iii), as amended by Pub. L. No. 116-94, Div. O, §103(b).

[784] Notice 2020-52.

[785] REG-115699-09, 74 Fed. Reg. at 23,137; *see* Reg. §1.401(a)(17)-1(b)(3)(iii). *See also* T.D. 9641, 78 Fed. Reg. at 68,736 (acknowledging the requirement).

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ed.[786] However, even for plan years beginning on or after January 1, 2020, if the plan provides for a matching contribution subject to ACP testing and the safe harbor nonelective contribution is being used to satisfy both the ADP test and the ACP test, then an annual notice is still required to be given to participants each year.

The timing and content of a wait-and-see notice is the same as for the standard annual notice required by Reg. §1.401(k)-3(d) except that the notice, instead of describing the safe harbor contributions, merely specifies that the plan may be amended during the plan year to include the safe harbor nonelective contributions and that, if it is so amended, a follow-up notice will be provided.[787] Thus, the wait-and-see notice generally is provided to employees a reasonable period before the start of the plan year and provides the "mini-SPD" required of safe harbor plans in general.

The follow-up notice must be provided no later than 30 days before the last day of the plan year, and must state that the safe harbor nonelective contributions will be made for the plan year.[788] This notice can be combined with the contingent notice for the next plan year.

Practice Insight: The wait-and-see safe harbor is a significant exception to the otherwise restrictive rules in the regulations that limit mid-year reductions and suspensions in safe harbor nonelective contributions. The employer may simply decide not to make required any nonelective safe harbor contributions under the wait-and-see approach, without any consequences other than having to satisfy the ADP test for the plan year. In contrast, an employer that suspends safe harbor nonelective contributions under the regulation's general exception for certain mid-year changes safe harbor must satisfy significant requirements, including establishing a substantial business hardship and applying a delayed effective date on any such amendment.[789]

5. *Effect of §401(k)(12) Safe Harbor Status on the §416 Top-Heavy Requirements*

The top-heavy rules do not apply to a §401(k)(12) safe harbor plan that only provides for safe harbor contributions.[790] Including a provision in the plan that merely allows for the option of additional contributions at the employer's discretion will also not cause the plan to be subject to the top-heavy rules.[791] However, any additional contribution actually made to the plan will cause it to be subject to the top-heavy rules.[792] This rule is strictly applied so that any allocation attributable to forfeitures will cause the plan to fall outside of the exemption from the top-heavy rules.[793]

If a §401(k)(12) plan falls outside of the top-heavy exemption, compliance with the top-heavy rules is often simplified as safe harbor nonelective contributions may be counted under §416 toward the minimum contribution requirement for top-heavy plans.[794] Thus, if a plan allocates to all eligible employees a 3%-safe-harbor nonelective contribution, the plan generally would also satisfy the top-heavy minimum contribution requirement.[795] In addition, matching contributions are taken into account in determining whether the top-heavy minimum contribution has been provided.[796] As a result, safe harbor matching contributions may also be counted toward the minimum contribution requirement for top-heavy plans under §416.

A safe harbor plan that is part of a top-heavy aggregation group is not considered a top-heavy plan if it only provides safe harbor contributions.[797] That is, the mere fact that it is part of a top-heavy aggregation group will not taint the relief. However, the entire plan within the meaning of §414(l) must be a safe harbor plan that only provides safe harbor contributions. In this regard, the IRS has ruled that a §401(k) plan that uses the permissive disaggregation rule of §410(b)(4) to apply §410(b) separately to the portion of a plan that benefits only employees who satisfy age and service conditions under the plan that are lower than the greatest minimum age and service conditions period under §410(a), must satisfy the §401(k)(12) safe harbor with respect to both portions of the plan in order to obtain the top-heavy relief in §416(g)(4)(H).[798]

6. *Effect of Automatic Contribution Arrangements in §401(k)(12) Safe Harbor Plans*

The §401(k)(12) safe harbor does not require that the CODA include an automatic contribution arrangement. In contrast to the §401(k)(13) safe harbor, a §401(k)(12) safe harbor may require affirmative elections to defer. However, nothing in §401(k)(12) precludes a plan from including an automatic contribution arrangement.

Practice Insight: One reason for a CODA that includes an automatic contribution arrangement to rely on §401(k)(12) rather than §401(k)(13) is that such a plan may utilize any design for its automatic contribution arrangement, rather than incorporating the detailed requirements for an automatic contribution arrangement under §401(k)(13), including its rigorous automatic escalation requirements. An additional incentive is that a §401(k)(12) safe harbor plan with an automatic enrollment feature may also be an eligible automatic contribution arrangement (an EACA) and, therefore, may offer §414(w) permissive in-service withdrawals.[799]

C. *Section 401(k)(13) Safe Harbor — Qualified Automatic Contribution Arrangements*

The design-based safe harbor of §401(k)(13) provides for automatic contributions at specified levels and offers the same relief from the nondiscrimination testing requirements that applies to a CODA that satisfies the §401(k)(12) safe harbor. Many of the rules that apply to a §401(k)(12) safe harbor plan

[786] Reg. §1.401(k)-3(f)(1). *See* Notice 2016-16, §III.B.

[787] Reg. §1.401(k)-3(f)(2). The availability of the contingent notice is not affected by the regulations governing mid-year reductions or suspensions of safe harbor nonelective contributions. T.D. 9641, 78 Fed. Reg. at 68,736.

[788] Reg. §1.401(k)-3(f)(3).

[789] Reg. §1.401(k)-3(g).

[790] §416(g)(4)(H), added by EGTRRA, Pub. L. No. 107-16, §613(d).

[791] Rev. Rul. 2004-13.

[792] Rev. Rul. 2004-13.

[793] Rev. Rul. 2004-13.

[794] Notice 98-52.

[795] See Reg. §1.416-1, M-18 for a similar rule applicable to qualified nonelective contributions.

[796] §416(c)(2)(A), as amended by EGTRRA, Pub. L. No. 107-16, §613(b), effective for years beginning after December 31, 2001.

[797] §416(g)(4)(H).

[798] Rev. Rul. 2004-13.

[799] §414(w)(3).

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also apply to a §401(k)(13) safe harbor plan.[800] Thus, the advantages of a §401(k)(13) safe harbor plan are that the CODA is: (i) treated as satisfying the ADP test; (ii) treated as satisfying the ACP test if the safe harbor matching contribution limits are observed and employee after-tax contributions are not permitted; and (iii) exempt from the top-heavy requirements of §416 for the year if the plan allows only employer matching or nonelective contributions required to satisfy the safe harbor requirements.

A plan will meet the design-based safe harbor of §401(k)(13) if the CODA satisfies all of the following: (i) the qualified automatic contribution arrangement requirement; (ii) the safe harbor contribution requirement; (iii) withdrawal and vesting requirements; (iv) the notice requirement; and (v) the plan year requirement.[801] Each of these requirements is discussed, in turn, below.

1. *Qualified Automatic Contribution Arrangement Requirement*

a. *Automatic Enrollment*

In order to satisfy §401(k)(13), a plan must include a qualified automatic contribution arrangement (QACA). A QACA must provide that all eligible employees are automatically enrolled in the plan, other than employees who have made an affirmative election either to make no contribution to the plan or to have a specified amount or percentage of compensation contributed to the plan as an elective contribution.[802] Thus, the effect of the QACA is a default election under which the employee is treated as having made an election to have a specified contribution made on his or her behalf under the plan.[803]

Automatic enrollment cannot be limited to certain groups of eligible employees, such as newly hired employees. In addition, existing employees as well as new hires must be automatically enrolled on the date the QACA is implemented, unless they have an affirmative election entered into previous to the date the QACA was implemented that remains in effect as of the QACA's effective date.[804]

Practice Insight: Existing eligible employees who are not contributing to the plan due to the failure to have made any election, such as having failed to complete enrollment or election forms, are not deemed to have made affirmative elections not to participate. As a result, such employees must be automatically enrolled in the plan on the date that the QACA is implemented. In other words, an employer must have on file, prior to the QACA effective date, an election to defer $0 or 0% of compensation in order to exclude the employee from automatic enrollment when the QACA is implemented. Note that these provisions assume that the plan was in existence as a non-safe-harbor 401(k) plan prior to becoming a §401(k)(13) plan and implementation of the QACA.

The regulations specifically provide that the default election under the automatic enrollment feature only applies for periods in which an affirmative election is not in effect.[805] As such, a plan may provide that affirmative elections expire as of a certain date, require employees to make new affirmative elections if they want the prior rate of elective contributions to continue, and automatically enroll employees at the plan's default percentage (based on the minimum percentage requirements discussed immediately below) if they do not make a second affirmative election.[806]

b. *Contribution Rates for Elective Deferrals*

In order to be a QACA, the plan must provide a default contribution rate for each eligible employee that is at least equal to a specified schedule of automatic contributions (called "qualified percentages"). The minimum qualified percentage during the initial period is 3% of compensation.[807] After the initial period, the minimum qualified percentage automatically increases by 1% for each of the next three plan years.[808] Thus, the minimum qualified percentage for the plan year after the initial period is 4%, increases to 5% for the next year, and then remains at 6% for all later plan years. However, the default qualified percentage cannot exceed 15% of compensation for any plan year.[809] The initial period begins when the employee first has contributions made pursuant to a default election under the QACA.[810]

Practice Insight: The schedule of automatic contributions represents only the minimum percentages that are required for each period under a QACA. As such, a plan may provide for higher default percentages or for any period or automatic increases that are greater than 1% of compensation. Alternatively, a plan can avoid automatic increases by providing for a single default percentage that is between 6% and 15% of compensation.

Minimum percentages are generally determined based on the number of years since the date an employee first had default contributions made under the QACA, without regard to whether an employee has continued to be eligible to make contributions under the plan.[811] Thus, the mere fact that an employ-

[800] §401(k)(13), added by 2006 PPA, Pub. L. No. 109-280, §902(a), and amended by Pub. L. No. 110-458, §109(b)(1), effective for plan years beginning after December 31, 2007.

[801] Reg. §1.401(k)-3, as amended by T.D. 9447, 74 Fed. Reg. 8200 (Feb. 24, 2009), as corrected at 74 Fed. Reg. 11,644 (Mar. 19, 2009), generally effective for plan years beginning on or after January 1, 2008.

[802] §401(k)(13)(C), as amended by SECURE Act of 2019, Pub. L. No. 116-94, Div. O, §102, effective for plan years beginning after December 31, 2019 (this legislation is also referred to as "SECURE 1.0" following the enactment of the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, on December 29, 2022). Under the SECURE Act, the 10% cap for the automatic enrollment safe harbor after the first plan year is increased to 15%. However, the limit during the first plan year remains at 10%, and may be increased to a maximum of 15% after the expiration of that period. *See* Reg. §1.401(k)-3(j)(1)(i) and §1.401(k)-3(j)(1)(ii). *See also* Notice 2024-2, Q&A J-1 (extending plan amendment deadlines under the SECURE 2.0 Act of 2022); Notice 2020-86, Q&A-1–3, *modified by* Notice 2022-33 (extending plan amendment deadlines provided in Notice 2020-86, Q&A-2–3).

[803] Reg. §1.401(k)-3(j)(1)(ii).

[804] Reg. §1.401(k)-3(j)(1)(iii).

[805] Reg. §1.401(k)-3(j)(1)(ii).

[806] T.D. 9447.

[807] §401(k)(13)(C)(iii)(I). *See* Reg. §1.401(k)-3(j)(2)(ii)(A).

[808] §401(k)(13)(C)(iii)(II) through §401(k)(13)(C)(iii)(IV). *See* Reg. §1.401(k)-3(j)(2)(ii)(B) through §1.401(k)-3(j)(2)(ii)(D).

[809] The maximum percentage was increased to 15% for plan years beginning after December 31, 2019, by the SECURE Act. §401(k)(13)(C)(iii) as amended by Pub. L. No. 116-94, Div. O, §102. For plan years beginning prior to December 31, 2019, the maximum percentage was 10% of compensation. Reg. §1.401(k)-3(j)(2)(i).

[810] Reg. §1.401(k)-3(j)(2)(ii)(A).

[811] Reg. §1.401(k)-3(j)(2)(iv); T.D. 9447.

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ee had a severance from employment after the initial contribution does not mean that the employee starts again at the initial automatic enrollment rate of 3% in the event of reemployment. The clock continues to run during the period in which the participant is not employed so that in the event of rehire the participant may need to be enrolled at a higher percentage.[812] However, there are special rules for determining an employee's initial period, including an important exception for re-hired employees, and a uniformity requirement also applies to the contributions rates. These rules are discussed in the following paragraphs.

c. Determining the Initial Period for Elective Deferral Contribution Rates

The initial period begins when the employee first participates in the automatic contribution arrangement that is intended to be a QACA and ends on the last day of the following plan year.[813] Thus, the initial period for a participant could be up to two full plan years.

The initial period is defined by reference to the first default contribution made on behalf of the employee.[814] If an employee makes an affirmative election before the default contribution would have begun, then the initial period does not begin for the employee.[815] Although the §401(k) regulations do not further define when the first default contribution is made, the §414(w) regulations, which also deal with automatic contribution arrangements, indicate that the date of the first default elective contribution is the date that the compensation that is subject to the cash or deferred election would otherwise have been includible in income, which generally is the date the first default contribution would have been paid to the employee but for the default election.[816] For a plan that previously had an automatic contribution arrangement and, thereafter, becomes a QACA, the initial period for an employee is based on the first default contribution after the date the QACA is effective, not the date of the first default contribution under the non-QACA automatic contribution arrangement.

As discussed above, minimum percentages are generally determined based on the number of years since the date an employee first had default contributions made under the QACA, without regard to whether an employee has continued to be eligible to make contributions under the plan. However, employers may take advantage of a rule of convenience in the regulations which allows a plan to provide that an employee who did not have contributions made pursuant to a default election under the QACA for an entire plan year to be treated as if the employee had not had such contributions for any prior plan.[817] This essentially allows an employer to begin a new initial period and restart automatic contributions at the minimum qualified percentage for an employee who terminates in one plan year, remains terminated for a full plan year, and is rehired in a subsequent plan year, regardless of whether the employee actually had contributions made pursuant to a default election under the QACA in some earlier plan year.[818]

d. Uniformity Requirement

A contribution percentage is a qualified percentage only if it is uniform for all employees.[819] In general, this means that the default percentage must be the same for every employee with the same number of years or portions of years since the beginning of the employee's initial period.[820] However, there are four regulatory exceptions to the uniformity rule that allow for variations in percentages in the following circumstances: (1) based on the number of years (or portions of years) since the beginning of the initial period for an eligible employee; (2) the percentage rate is not reduced due to an election to make deferrals at a higher rate being in effect immediately before the effective date of the QACA default rate; (3) to apply the limits of §402(g), §415, and §401(a)(17); and (4) to apply the six-month contribution suspension requirement for hardship distributions for plan years beginning before January 1, 2020.[821]

The exception for variations in percentages based on the number of years (or portions of years) since the beginning of the initial period accommodates a number of different timing rules for automatic increases. For example, automatic increases may be implemented as of the first day of each plan year, as of the anniversary of the date of the employee's first contribution under the automatic contribution arrangement or on the date of the first annual pay increase following the date of the first contribution under the plan. In each case, the controlling factor in the default percentage would be the number of years or portions of years since the initial default contribution.

Practice Insight: It is not entirely clear whether the exception based on the number of years (or portions of years) since the beginning of the initial period accommodates other variations in the scheduled increase date. In this regard, for example, some automatic contribution arrangements base the date of the scheduled increase by reference to an employee's date of hire, the date on which the employee was first eligible to participate (which may be different from the date of the initial contribution), or the date the first contribution was received by the plan's trust. These automatic escalation dates are not derived from the date of the initial contribution, but one might fairly reason that the percentage varies solely based on the duration from the initial contribution in the same manner as any other scheduled increase. Further, it is somewhat intuitive that these methods of automatic escalation treat all employees in a uniform manner.

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[812] Reg. §1.401(k)-3(j)(2)(iv).
[813] §401(k)(13)(C)(iii)(I); Reg. §1.401(k)-3(j)(2)(ii)(A).
[814] Reg. §1.401(k)-3(j)(2)(ii)(A).
[815] T.D. 9447.
[816] Reg. §1.414(w)-1(c)(2)(ii).
[817] Reg. §1.401(k)-3(j)(2)(iv).
[818] T.D. 9447.
[819] §401(k)(13)(C)(iii), as amended by Pub. L. No. 116-94, Div. O, §102, effective for plan years beginning after December 31, 2019. Under the SECURE Act, the 10% cap on escalation of contributions for the automatic enrollment safe harbor after the first plan year is increased to 15%. However, the maximum limited for the period reflected in §401(k)(13)(C)(iii)(I) (period within which the minimum qualified percentage is 3%) remains at 10%, and may not be increased to a maximum of 15% until after the expiration of that period. *See* Notice 2024-2, Q&A J-1 (extending plan amendment deadlines under the SECURE 2.0 Act of 2022); *see also* Notice 2020-86, Q&A-1–3, *modified by* Notice 2022-33 (extending plan amendment deadlines provided in Notice 2020-86, Q&A-2–3).
[820] Reg. §1.401(k)-3(j)(2).
[821] Reg. §1.401(k)-2(j)(2)(iii)(A)–§1.401(k)-2(j)(2)(iii)(D).

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In Rev. Rul. 2009-30, the IRS addressed a QACA that provided for scheduled increases beginning on a specified pay period that coincided with the pay period in which the employer generally implemented pay increases. The ruling concluded that the arrangement would not fail to satisfy the qualified percentage requirement, including uniformity and minimum percentage requirements, merely because default contributions were pursuant to an arrangement under which the default contribution percentage for all eligible employees increases on a date other than the first day of a plan year. This conclusion is consistent with the exception based on number of years of service (or portion of years), as the scheduled increase date was the same date for all employees and did not vary based on any particular employee's circumstances. Notably, the ruling did not address percentage increases tied to individual pay raises, which could occur on different dates for different employees.

The regulations are silent on the effect of a §414(w) permissible withdrawal of the initial contribution, if the plan was also designed to be an eligible automatic contribution arrangement, which is discussed in VI., below. However, there is nothing to suggest that the contribution subject to the withdrawal would cease to be considered an initial contribution, assuming the employee is subsequently reenrolled or did not opt out of participation in connection with the withdrawal.

The regulations do not explicitly address whether it is permissible for a §401(k)(13) safe harbor plan to allow participants to make affirmative deferral elections prior to the effective date of the automatic contribution arrangement. The statute and the regulations provide that the automatic contribution arrangement must apply to each employee who is eligible to participate in the CODA, which suggests that automatic enrollment must occur in connection with initial eligibility.[822] However, as discussed below, the regulations specifically provide that the default election may not be effective any earlier than "a reasonable period of time after receipt of the notice" explaining the arrangement.[823] The regulations, however, set a back-end limit by providing that this rule does not permit a plan to make the automatic enrollment effective later than a specified date, which is the earlier of the pay date for the second payroll period that begins after the date the notice was provided and the first pay date that occurs at least 30 days after the notice is provided.[824] Taken as a whole, this suggests that a plan may allow employees to make affirmative elections prior to the date on which the automatic enrollment is effective in order to ensure that employees have a reasonable period of time to consider the default election, but cannot delay the effective date of the automatic contribution arrangement beyond the specified date described above.

The uniformity requirement applies to the plan within the meaning of §414(l), but the uniformity requirement does not apply across portions of the plan that are subject to disaggregation under the rules of §410(b) so that collectively bargained employees may be covered by a QACA with one contribution structure while non-collectively bargained employees are covered by a QACA with a different contribution structure.[825] Similarly, an employer may maintain two or more §401(k) plans, each with a different automatic enrollment structure and each a QACA. In effect, the same aggregation and disaggregation rules that apply to §401(k)(12) plans, discussed above, also apply to determine the plan subject to the uniformity requirement.

e. Definition of Compensation Used for Elective Deferral Contribution Rates

The definition of compensation that is used to determine whether the plan is providing the minimum required deferral rate is safe harbor compensation within the meaning of Reg. §1.401(k)-3(b)(2), which incorporates the definition of compensation in §414(s) and Reg. §1.414(s)-1, except that the plan may not exclude compensation in excess of a specific amount for non-highly compensated employees (i.e., the rule in the last sentence of Reg. §1.414(s)-1(d)(2)(iii) does not apply).[826]

This rule differs from the one applied under the §401(k)(12) safe harbor. The §401(k)(12) safe harbor, for example, provides that an eligible employee must be permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of Reg. §1.414(s)-1(d)(2) (without regard to whether the definition satisfies the nondiscrimination requirement of Reg. §1.414(s)-1(d)(3)). In contrast, under §401(k)(13), the definition of compensation used for determining the minimum percentages must satisfy the §414(s) nondiscrimination requirements. Otherwise, however, the same compensation rules that apply under the §401(k)(12) safe harbor also apply §401(k)(13) safe harbor plans. Thus, for example, the plan may limit the types of compensation that may be deferred by an eligible employee under the plan, provided that each non-highly compensated employee who is an eligible employee is permitted to make elective contributions under a definition of compensation that would be a reasonable definition of compensation within the meaning of Reg. §1.414(s)-1(d)(2) (without regard to whether the definition satisfies the nondiscrimination requirement of Reg. §1.414(s)-1(d)(3)).[827]

2. Safe Harbor Contribution Requirement

The same matching and nonelective contribution requirements for a §401(k)(13) safe harbor apply to a §401(k)(12) safe harbor plan, subject to one exception that makes the basic matching formula under §401(k)(13) somewhat more modest. The plan must provide that matching contributions to be made on behalf of each eligible non-highly compensated employee are equal to 100% of the employee's compensation, and 50% of the employee's elective contributions that exceed 1% and do not exceed 6% of compensation.[828] Thus, the maximum required matching contribution under §401(k)(13) is equal to 3.5% of compensation, not 4% of compensation.

The same rate of nonelective contributions is required under both the §401(k)(12) and §401(k)(13) safe harbors. There

[822] §401(k)(13)(C)(i).

[823] Reg. §1.401(k)-3(k)(4)(iii).

[824] Reg. §1.401(k)-3(k)(4)(iii).

[825] Reg. §1.414(w)-1(b)(2)(iii).

[826] The §414(s) compensation requirement as a measure of the minimum qualifying percentages applies only to plan years beginning on or after January 1, 2010.

[827] Reg. §1.401(k)-3(c)(6)(iv).

[828] *Compare* §401(k)(13)(D)(i) and Reg. §1.401(k)-3(k)(2) *with* §401(k)(12)(B)(i) and Reg. §1.401(k)-3(c)(2).

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is no reduced rate of qualifying nonelective contributions for a §401(k)(13) safe harbor plan that includes a qualified automatic contribution arrangement, as the same 3% minimum applies. See IV.B.1., above, for a discussion of the safe harbor contributions requirements of §401(k)(12).

For plan years beginning after 2019, a plan may be amended to add required nonelective contributions after the beginning of a plan year when the amendment is adopted either (1) no later than the 30th day before the end of the plan year; or (2) at any time before the last day by which excess contributions must be distributed for that plan year. Further, such an amendment will meet the safe harbor requirements where the minimum nonelective contribution established is at least 4% of the employee's compensation. If, however, a plan provided for matching contributions at any time during the plan year, this exception will not apply.[829]

3. *Withdrawal and Vesting Requirements*

A §401(k)(13) safe harbor plan may impose a vesting requirement on safe harbor employer contributions. The vesting schedule must provide for full vesting once an employee has completed at least two years of service (within the meaning of §411(a)).[830] However, the same withdrawal restrictions for §401(k)(12) safe harbor contributions apply to a §401(k)(13) safe harbor plan. See IV.B.2., above, for a discussion of the withdrawal requirements of §401(k)(12).

4. *Notice Requirement*

The notice requirement for a §401(k)(13) safe harbor plan is generally the same notice requirement that applies to a §401(k)(12) safe harbor plan but additional information must be included to reflect the presence of a qualified automatic contribution arrangement and a special timing rule applies.[831]

For plan years beginning after December 31, 2019, the SECURE Act eliminated the safe harbor notice requirement for §401(k)(13) plans that use nonelective contributions but not for plans that use matching contributions.[832] Presumably, the notice requirement continues to apply to §401(k)(13) plans that use nonelective contributions to satisfy the ADP safe harbor but also provide for matching contributions, as the SECURE Act did not amend the notice requirements as they relate to the ACP safe harbor of §401(m)(11).[833]

In the case of a QACA under §401(k)(13), the notice must also explain: (i) the level of elective contributions that will be made on the employee's behalf if the employee does not make an affirmative election; (ii) the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf (or to elect to have such contributions made in a different amount or percentage of compensation); and (iii) how contributions under the arrangement will be invested, including, in a participant-directed plan, how contributions will be invested in the absence of an affirmative investment election.[834] The notice may not simply refer to the plan's SPD on these points.[835]

For plan years beginning after 2019, the notice requirement is limited to matching contributions, and is no longer required with respect to nonelective contributions.[836]

Similar to the timing rules for providing notice regarding a §401(k)(12) safe harbor plan, the notice for a §401(k)(13) safe harbor plan must be provided within a reasonable period of time before any plan year or, in the case of a new hire, before the day the employee becomes eligible to participate.[837] Further, the notice is treated as timely provided it is provided at least 30 days (and no more than 90 days) before the beginning of the plan year or, if later, within the 90-day period ending with the date the employee becomes eligible to participate.[838]

However, in the case of a QACA under §401(k)(13), the notice must be provided sufficiently early so that the employee has a reasonable period of time after receipt of the notice to make an affirmative deferral election and, if the plan permits participant investment direction, to make an affirmative investment election.[839] However, the regulations also create a backend date by which automatic enrollment must be effective, specifying that the default election must be effective no later than the earlier of: (i) the pay date for the second payroll period that begins after the date the notice is provided; and (ii) the first pay date that occurs at least 30 days after notice is provided.[840]

Practice Insight: The timing requirement for a QACA that provides for immediate eligibility to participate can be challenging, particularly if the eligible employees are paid on a frequent basis, such as a weekly payroll. The default enrollment in such a circumstance may need to be effective as soon as two weeks after the date of hire.

5. *Plan Year Requirement*

The same plan year requirement that applies to a §401(k)(12) safe harbor plan also applies to a §401(k)(13) safe harbor plan.[841] This means that same rules that apply to §401(k)(12) plans with regard to mid-year changes, suspensions, and reductions of safe harbor contributions, the wait-and-see option for nonelective contributions, and the related notice requirements also apply to §401(k)(13) safe harbor plans. See the discussion of the plan year requirements in IV.B.4., above.

[829] §401(k)(13)(F), added by Pub. L. No. 116-94, Div. O, §103(c), effective for plan years beginning after December 31, 2019. See Notice 2020-86 for interim guidance on changes enacted under §102 and §103 of the SECURE Act.

[830] *Compare* §401(k)(13)(D)(iii) and Reg. §1.401(k)-3(k)(3) *with* §401(k)(12)(E)(i).

[831] Reg. §1.401(k)-3(a)(2), §1.401(k)-3(k)(1), §1.401(k)-3(k)(4); *compare* §401(k)(13)(E) *with* §401(k)(12)(D).

[832] §401(k)(13)(B), as amended by Pub. L. No. 116-94, Div. O, §103(a)(1).

[833] §401(m)(11)(A)(ii); *see* Notice 2020-86, Q&A-4.

[834] Reg. §1.401(k)-3(k)(4). Failure to provide the notice is subject to penalties of up to $1,000 per day (as adjusted for inflation). *See* ERISA §502(c)(4); 29 C.F.R. §2560.502c-4, 29 C.F.R. §2575.3. For a table of the current and prior DOL penalties imposed on an ERISA plan, see the Worksheets of 361 T.M., *Reporting and Disclosure Under ERISA*.

[835] REG-133300-07, 72 Fed. Reg. 63,144, 63,147 (Nov. 8, 2007) (preamble to proposed regulations that were adopted as modified by T.D. 9447, 74 Fed. Reg. 8200 (Feb. 24, 2009)).

[836] §401(k)(13)(B), as amended by Pub. L. No. 116-94, Div. O, §103(a)(2), effective for plan years beginning after December 31, 2019. See Notice 2020-86, Q&A-4-7.

[837] Reg. §1.401(k)-3(a)(2), §1.401(k)-3(d)(3)(i).

[838] Reg. §1.401(k)-3(d)(3)(ii).

[839] Reg. §1.401(k)-3(k)(4)(iii).

[840] Reg. §1.401(k)-3(k)(4)(iii).

[841] Reg. §1.401(k)-3(a)(2).

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6. *Comparison of §401(k)(12) and §401(k)(13) Safe Harbors*

The §401(k)(12) and §401(k)(13) safe harbors are very similar in that they both provide relief from the ADP and ACP testing requirements and from the application of the §416 top-heavy rules. In addition, both types of safe harbor plans may be designed to include an automatic contribution arrangement. However, a §401(k)(12) safe harbor plan with an automatic contribution arrangement is not subject to the qualified minimum percentages and the uniformity requirement that apply to a §401(k)(13) safe harbor plan. This makes it is possible to design a §401(k)(12) plan with an automatic contribution arrangement that only applies to new hires or that provides for contribution percentages that do not follow the qualified minimum percentage requirements.

Two other significant differences between a §401(k)(12) safe harbor plan and a §401(k)(13) safe harbor plan with a QACA are that the §401(k)(13) safe harbor permits the use of a vesting schedule,[842] and the matching contribution requirement under the §401(k)(12) safe harbor is modestly higher than the matching contribution requirement under the §401(k)(13) safe harbor.[843]

D. Section 414(x) Eligible Combined Plans — DB(k) Plans

Section 414(x) provides special rules that permit a small employer to maintain an "eligible combined plan," consisting of a defined benefit plan and §401(k) plan, which is deemed to satisfy the ADP and ACP tests and is exempt from the top-heavy requirements of §416.[844] Thus, this arrangement is another type of design-based safe harbor plan and is often referred to as a "DB(k)" plan or arrangement. In addition, DB(k) plans provide relief from the administrative costs and burdens associated with maintaining two separate retirement plans by requiring that the assets of both plans be held in a single trust and only one Form 5500 be filed.[845]

DB(k) plans are relatively new, having been added to the Code and ERISA effective for plan years beginning in 2010. There has been very little guidance issued with respect to DB(k) plans, other than a 2009 IRS notice, which also requests comments regarding possible issues to be addressed in future guidance, but no future guidance has been issued to date.[846]

In order to constitute a DB(k) plan within the meaning of §414(x) —

(1) the arrangement must be maintained by a small employer at the time it is established;

(2) the arrangement must consist of a defined benefit plan and a defined contribution plan that includes a CODA;

(3) the assets of the two plans must be held in a single trust with separate accounting for the relative interests of the plans; and

(4) the plans must satisfy certain benefit, contribution, vesting, and nondiscrimination requirements, including a minimum level of accrued benefits under the defined benefit portion of the plan, minimum level of employer matching contributions under the defined contribution portion of the plan, an automatic contribution arrangement, and a uniformity requirement.[847]

Notwithstanding the single trust requirement and the statute's description of a DB(k) arrangement as an "eligible combined plan," §414(x)(1) specifically states that the requirements of the Code shall be applied to the defined benefit and defined contribution portions of the plan as if each such plan were a separate plan and not part of the eligible combined plan — except as otherwise provided in §414(x). As such, the defined benefit and defined contributions portions of the plan are largely treated as two separate plans, as discussed in more detail below.

1. *Small Employer Requirement*

The DB(k) rules are only available to an employer that is considered a "small employer" at the time the plan is established.[848]

A small employer is an employer who employed on average at least two but not more than 500 employees on business days during the calendar year preceding the year in which the DB(k) arrangement was established and at least two employees on the first day of the plan year, determined using the rules of §4980D(d)(2).[849] In the case of an employer that was not in existence during the preceding calendar year, the determination of whether an employer is a small employer is based on the average number of employees that it is reasonably expected that such employer will employ on business days in the current calendar year.[850] For these purposes, any predecessor employers will be taken into account.[851] For purposes of determining the number of employees of the employer, all employers that are aggregated under §414(b), §414(c), §414(m), or §414(o) are considered the employer so that all employees of the controlled group employer are taken into account.[852]

DB(k) arrangements are not available to owner-only plans because such plans by definition do not cover at least two employees. Similarly, DB(k) plans are not available to large employers, including smaller subsidiaries or affiliates of large employers. However, an employer that grows beyond the employee limit will still be able to rely on the special rules for its DB(k) arrangement because the determination is made "at the time the plan is established."[853] This also means that a small employer that adopts a DB(k) plan and, thereafter, is acquired by a large employer will not be adversely affected by the acquisition. It is not clear, however, whether the DB(k) arrangement may be extended to the employees of the acquiring employer after the acquisition, although the statute and the legislative history do not impose any such limitation.

[842] §401(k)(13)(D)(iii).
[843] *Compare* §401(k)(12)(B) *with* §401(k)(13)(D).
[844] §414(x)(3), §414(x)(4).
[845] §414(x)(2)(A)(iii), §414(x)(6).
[846] Notice 2009-71.
[847] §414(x)(2).
[848] §414(x)(2)(A)(i).
[849] §414(x)(2)(A) (flush language), §4980D(d)(2)(A).
[850] §4980D(d)(2)(B).
[851] §4980D(d)(2)(C).
[852] §4980D(d)(2)(A).
[853] §414(x)(2)(A)(i).

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2. Separate Defined Benefit Plan and Defined Contribution Plan Requirement

A DB(k) arrangement largely operates in effect as two separate plans, one that satisfies the defined benefit plan rules and one that satisfies the rules applicable to a plan that includes a qualified CODA.[854] Each plan must satisfy the tax-qualification requirements of the Code, as well as the requirements of §414(x) that are to be applied separately, as if such plan were not part of an eligible combination plan. As a result, for example, the §415 limits on contributions and benefits apply to each plan separately as if each plan were not part of an eligible combination plan.[855] In addition, the spousal consent requirements apply to each plan separately so that the defined benefit plan will generally be subject to the spousal consent requirements and the defined contribution plan will typically not be subject to the spousal consent requirements.[856] Further, the minimum funding rules will apply to the defined benefit plan to the same extent that the funding rules would apply if the plan were not part of a DB(k) arrangement.[857] It is also implicit under §414(x) that a DB(k) arrangement will not violate §401(k)'s prohibition on a qualified CODA being part of a defined benefit plan simply because the two plans are funded through a single trust.

It appears that an eligible combination plan is treated as two separate plans for purposes of §414(l), which generally defines a single "plan," because the assets of the plan that are attributable to one plan are not available to pay benefits under the other plan.[858] As a result, for example, the fact that the defined benefit plan is underfunded should not adversely affect the defined contribution plan. This is supported by legislative history indicating that separate participant accounts are to be maintained under the defined contribution portion of the arrangement, and earnings or losses are based on the assets allocable to the defined contribution plan.[859] It is also supported by §414(x)(6)(B), which indicates that an eligible combined plan must be treated as a single plan for purposes of information reporting — a provision that would not be necessary if an eligible combination plan were treated as a single §414(l) plan.

Each plan must be terminated separately if there is a termination of the defined benefit plan and the defined contribution plan forming part of an eligible combination plan.[860] Although not explicitly addressed, this suggests that a DB(k) plan may be discontinued by spinning off the defined benefit and defined contribution portions of the plan into two separate plans, which thereafter would need to satisfy the general tax-qualification rules without regard to §414(x).

It also appears that an existing plan, such as an existing §401(k) plan, may become part of a §414(x) eligible combined plan. This might occur, for example, if a defined benefit plan was adopted by the employer in connection with an existing qualified CODA and the two arrangements were maintained pursuant to a single trust. It might also occur through the "merger" of an existing defined benefit plan and an existing qualified CODA. There do not appear to be any particular statutory barriers in §414(x) to the use of existing plans. The IRS generally takes the position that a defined contribution plan and a defined benefit plan may not be merged.[861] This prohibition, however, is rooted in the anti-cutback rule of §411(d)(6), which generally treats the defined contribution or defined benefit character of a plan as a protected benefit. In the DB(k) context, the essential character of each type of plan must be protected, which suggests that existing plans may serve as the foundation of a DB(k) arrangement. There is also legislative history that explicitly suggests existing plans may become part of an eligible combination plan.[862]

3. Single Trust Requirement

Section 414(x) requires that the defined benefit and defined contribution portions of the DB(k) arrangement be funded through a single trust.[863] However, the assets of each component plan must be clearly identified and allocated to the extent necessary to separately apply and satisfy the other requirements of §414(x).[864] This asset segregation rule is necessary to apply the general mandate of §414(x), which requires that except as otherwise provided, all tax-qualification rules of the Code are to be applied as if each plan were not part of an eligible combined plan. As such, the significance of the single trust requirement appears to be largely intended to facilitate ease of reporting for small employers by requiring only a single summary annual report to be provided, the ability to file one Form 5500 for both plans each year, and to have only one audit performed for plans subject to the audit requirement.[865]

4. Benefit Accrual, Contribution, Vesting, and Nondiscrimination Requirements

As discussed above, an employer must maintain both a defined benefit plan and a defined contribution arrangement, each of which meets certain requirements, for the arrangement to be an eligible DB(k) plan. The defined benefit portion of the DB(k) plan must provide a minimum accrued benefit, and the defined contribution portion must contain an automatic contribution arrangement and provide a certain level of matching contributions.[866] In addition, there are special vesting requirements and rules for applying nondiscrimination tests, and a uniformity requirement also applies. These requirements are discussed below.

a. Defined Benefit Plan Accrual Requirements

The defined benefit plan that forms part of the DB(k) plan must provide each participant with a minimum employer-provided accrued benefit and may be either a final average pay

[854] §414(x)(1), §414(x)(7).
[855] 2006 PPA Bluebook at 236.
[856] 2006 PPA Bluebook at 236.
[857] 2006 PPA Bluebook at 236.
[858] Reg. §1.414(l)-1(b)(1), noting that whether an arrangement is one §414(l) plan turns on whether the assets are available to pay benefits, even if a single trust is used.
[859] 2006 PPA Bluebook at 236.
[860] §414(x)(1), as amended by Pub. L. No. 110-458, §109(c)(1), effective for plan years beginning after 2009.
[861] *See* Reg. §1.411(d)-4, Q&A-3(a)(2).
[862] 2006 PPA Bluebook at 238, discussing benefits, rights, and features testing on pre-merger features.
[863] §414(x)(1), §414(x)(2)(A)(iii).
[864] §414(x)(2)(A)(iii).
[865] §414(x)(6).
[866] §414(x)(A), §414(x)(B), §414(x)(C).

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plan or a cash balance plan.[867] In general, the accrued benefit of each participant derived from employer contributions, when expressed as an annual retirement benefit, must not be less than the applicable percentage of the participant's final average pay.[868] The minimum benefit formula depends on whether the plan is a final average pay plan or a cash balance plan.

For a final average pay plan, the minimum benefit must be at least 1% of final average compensation per year of service up to 20 years.[869] The benefit must be expressed as an annual benefit and must be employer-provided.[870] That is, employee contributions may not be required as a condition of the minimum benefit. Years of service are generally determined by reference to the §411 vesting rules, although a plan may not disregard a period of service solely because a participant is not contributing to the defined contribution plan portion of the arrangement.[871] Final average compensation is compensation determined over the five consecutive years in which the participant has the highest aggregate compensation.[872] Presumably, a shorter period may be used if the participant has fewer than five consecutive years of service.

In lieu of a final average pay formula, a DB(k) may provide a cash balance benefit that provides certain minimum pay credits that depend on the age of a participant.[873] The minimum pay credits must be no less than 2% of compensation if the participant is age 30 or less; 4% if the participant is over age 30 but less than age 40; 6% if the employee is age 40 or over but less than age 50; and 8% of compensation if the participant is age 50 or older. All ages are determined as of the first day of the plan year.[874]

The interest credits on the cash balance accounts must satisfy the interest rate requirements of §411(b)(5)(B)(i).[875] These interest rate requirements generally provide that a cash balance account cannot provide interest credits at a rate which is above a market rate of return and cannot provide a rate of return that may result in the account being less than the aggregate amount of compensation credits to the account.[876]

Practice Insight: The §411(b)(5)(B)(i) rules do not prescribe minimum rates of return other than a guarantee of principal. Taken literally, this might suggest that a cash balance plan might meet the requirements of §414(x) by simply providing compensation credits and no interest credits. This analysis would, however, be at odds with the purpose of requiring a defined benefit plan that provides a minimum benefit.

The statute does not specify the normal retirement age that must be used by the DB(k) plan, but presumably an employer is not free to set a normal retirement age that is exceptionally late since that would reduce the economic value of the minimum benefit. The statute uses the term "accrued benefit," which is defined in §411(a)(7) to mean the benefit under the defined benefit plan, expressed in the form of an annual benefit commencing at normal retirement age. The term "normal retirement age" is defined in §411(a)(8) such that it cannot be later than attainment of age 65 (except for participants that commence participation within five years of normal retirement age), which suggests that this is the relevant rule for purposes of a DB(k) plan. A related question is whether there is a limit on the discount rate for early commencement of retirement benefits. Presumably the discount rate cannot be so steep as to cause a forfeiture, which would violate §411. In addition, §417(e), which provides rules on determining the present value of accrued benefits payable in a lump sum from a defined benefit plan, may apply to set limits where the DB(k) plan provides for a lump sum payable upon early retirement.

b. Section 401(k) Plan Contribution Requirements

In addition to the required minimum accrued benefit, the CODA portion of the DB(k) plan must provide matching contributions of 50% of at least 4% of compensation.[877] Alternatively, the plan may provide for a different rate of matching contribution, provided that the rate of matching contribution does not increase as the participant's rate of elective contribution increases, and the aggregate amount of matching contributions at each rate of elective contribution is no less than the aggregate amount of matching contributions that would be provided under the basic matching contribution requirement.[878] Thus, for example, an enhanced matching contribution formula might provide matching contributions equal to 100% of the first 2% of compensation that is contributed to the plan. However, in no case may the rate of matching contribution for any elective contribution of a highly compensated employee at any rate of elective contribution be higher than the rate of matching contribution for a non-highly compensated employee.[879] In this regard, the same rules that apply to a §401(k)(12) or §401(k)(13) safe harbor apply to the safe harbor matching contribution under a DB(k) plan.

There is no safe harbor nonelective contribution alternative for a DB(k) arrangement, unlike a safe harbor plan under §401(k)(12) or §401(k)(13), which means that matching contributions are required. However, the defined contribution portion of the DB(k) plan can provide for nonelective employer contributions, but such nonelective contributions are not taken into account in determining whether the matching contribution requirements are met.[880]

If the CODA portion of the DB(k) plan provides the minimum contribution (and does not provide for after-tax employee contributions or additional matching contributions), the plan is deemed to satisfy the ACP test.[881] Note that this is at a reduced rate of matching contributions relative to the ACP safe harbor that applies under §401(m)(11), reflecting that a portion of the employer-provided benefit is provided through the defined benefit plan that is part of the DB(k) arrangement. The defined contribution element of a DB(k) plan may provide for addition-

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[867] §414(x)(2)(B).
[868] §414(x)(2)(B)(i).
[869] §414(x)(2)(B)(ii).
[870] §414(x)(2)(B)(i).
[871] §414(x)(2)(B)(iv). *See* §411(a)(4), §411(a)(5),§411(a)(6).
[872] §414(x)(2)(B)(i).
[873] §414(x)(2)(B)(iii).
[874] 2006 PPA Bluebook at 236.
[875] §414(x)(2)(B)(iii).
[876] §411(b)(5)(B)(i). For discussion of the interest credit rules, see 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age-Weighted and Hybrids*.

[877] §414(x)(2)(C)(i)(II).
[878] §414(x)(2)(C)(i) (flush language), §401(k)(12)(B)(iii); Notice 2009-71.
[879] §414(x)(2)(C)(i) (flush language), §401(k)(12)(B)(ii).
[880] §414(x)(2)(C)(ii).
[881] §414(x)(3)(B), applying §401(m)(11) standard.

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al matching contributions.[882] If additional matching contributions are provided, the matching contributions must satisfy the ACP test or the §401(m)(11) safe harbor, modified to reflect the lower matching contribution rate required under §414(x). The same limits that apply to additional matching contributions under the §401(m)(11) safe harbor that apply to §401(k) plans generally apply to DB(k) plans, including, for example, the 6% limit on total matching contributions.

Practice Insight: To some extent, the DB(k) rules address the inequity in the current safe harbor §401(k) plan rules that ignore whether the employer is maintaining a defined benefit plan and look solely to the level of employer contributions to the §401(k) plan. In this regard, they allow an employer to satisfy a portion of the contribution requirement through its defined benefit plan.

The statute is silent on whether after-tax employee contributions may be made to either the defined contribution or defined benefit portion of the DB(k) plan. There does not, however, appear to be any rule that would prohibit such contributions. Nonetheless, after-tax employee contributions to the defined contribution plan would trigger the ACP test and would preclude reliance on the §401(m)(11) safe harbor.

c. Automatic Contribution Arrangement Requirement

The qualified CODA must be an automatic contribution arrangement which provides that each employee eligible to participate in the arrangement is treated as having elected to make elective contributions in an amount equal to 4% of the employee's compensation unless the employee specifically elects not to have such contributions made or to have such contributions made at a different rate.[883] This does not appear to be a minimum rate but, rather, the required rate for automatic enrollment, unlike a §401(k)(13) QACA. Similar to the §401(k)(13) safe harbor, however, it appears that the §414(x) automatic contribution arrangement under a DB(k) plan must apply to all employees that have not made a prior affirmative election to participate, including existing employees.[884]

d. Definition of Compensation

The statute does not specify a required definition of compensation that must be used in meeting the matching contribution and benefit accrual requirements. Presumably rules similar to the rules that apply to the §401(k)(12) and §401(k)(13) safe harbors also apply to matching contributions made under §414(x). These rules generally provide that safe harbor employer contributions must be based on a definition of compensation within the meaning of Reg. §1.401(k)-6, which incorporates the definition of compensation under §414(s), but without the ability to exclude all compensation in excess of a specified dollar amount.[885] As a result, for example, the definition of compensation that is used to measure safe harbor employer contributions may exclude bonuses, commissions, overtime, and other items of compensation provided that the definition of compensation does not by design favor HCEs, is reasonable within the meaning of Reg. §1.414(s)-1(d)(2), and satisfies the nondiscrimination requirements of Reg. §1.414(s)-1(d)(3).

e. Effect of Other Plans in Applying Nondiscrimination Rules

The minimum benefit and contribution requirements applicable to the defined benefit plan and defined contribution plan portions of the DB(k) plan must be met without application of the permitted disparity rules under §401(l).[886] In addition, the defined benefit plan and defined contribution plan must meet the nondiscrimination requirements under §401(a)(4) and the minimum coverage requirements under §410(b) without application of the permitted disparity rules and without being combined with any other plan.[887]

f. Vesting and Withdrawal Requirements

A DB(k) arrangement must satisfy specified vesting requirements. In particular, the defined benefit plan must provide that a participant is fully vested after completion of three years of service and may provide for a more favorable vesting schedule.[888] A similar rule applies for nonelective employer contributions to the defined contribution plan.[889] In addition, matching contributions must be fully vested immediately.[890]

Practice Insight: Employer contributions to a defined contribution plan must generally be vested once a participant has completed three years of service. However, §411 permits an alternative vesting schedule that provides graded vesting over six years. The graded vesting schedule is apparently not permitted under a §414(x) eligible combination plan.[891]

Additional matching contributions must be fully vested immediately. It is not permissible to impose a vesting schedule on additional matching contributions.[892] This is different from the §401(m)(11) safe harbor which permits a vesting schedule on additional matching contributions but imposes overall limits as a condition of preserving the ACP safe harbor.

Unlike a §401(k)(12) or §401(k)(13) safe harbor plan, there are no special restrictions on withdrawals from an eligible combination plan. Rather, elective deferrals under the §401(k) plan are subject to the in-service withdrawal restrictions that generally apply to such contributions discussed in II.C., above. The matching contributions are subject to the restrictions that apply to matching contributions generally, not to matching contributions under a safe harbor plan. Further, the distributions from the defined benefit plan are subject to the in-service distribution restrictions applicable to such plans generally, which generally limit in-service distributions to the earlier of age 62 or normal retirement age.[893]

[882] The statute is not explicit about additional matching contributions. However, §414(x)(2)(D)(ii) specifies a vesting schedule for additional matching contributions and the legislative history indicates that matching contributions may satisfy the ACP test, which would not be relevant unless additional matching contributions are permitted. 2006 PPA Bluebook at 238.

[883] §414(x)(5)(A)(i).

[884] *See* §414(x)(5)(A)(i).

[885] Reg. §1.401(k)-3(b)(2).

[886] §414(x)(2)(F)(ii)(I).

[887] §414(x)(2)(F)(ii)(II), §414(x)(2)(F)(iii).

[888] §414(x)(2)(D)(i).

[889] §414(x)(2)(D)(ii)(II).

[890] §414(x)(2)(D)(ii)(I).

[891] §414(x)(2)(D) (flush language).

[892] §414(x)(2)(D)(ii)(I).

[893] §401(a)(36), as amended by Pub. L. No. 116-94, Div. M, §104(a), effective for plan years beginning after December 31, 2019; Reg. §1.401(a)-1(b). Note that while Pub. L. No. 116-94, Div. M, §104, lowered the age for in-ser-

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g. Uniformity Rule; Effect of Additional Accruals or Employer Contributions

A DB(k) plan may provide for additional accruals under its defined benefit plan and additional contributions under its defined contribution plan. However, §414(x)(2)(E) requires that all contributions and benefits under each of the defined benefit and defined contribution plans, and all rights and features under each such plan, must be provided uniformly to all participants. This requirement is far more stringent than the §401(a)(4) nondiscrimination rules and applies even if a plan would otherwise satisfy the general nondiscrimination rules.

Practice Insight: The alternative cash balance formula does not, strictly speaking, provide uniform benefits. It provides different pay credits to different participants based on age. Query whether this suggests that age-based formulas should satisfy the uniformity requirement.

The uniformity requirement also applies to benefits, rights, and other features under the DB(k) arrangement.[894] A limited exception applies under the legislative history to the extent a benefit, right, or feature is attributable to a benefit that was accrued before a defined benefit or defined contribution plan became part of a DB(k) arrangement.[895] This limitation may make it difficult for the defined benefit plan component of the arrangement to make changes in the plan, for example, changing distribution options.

Although nonelective contributions are not an option for satisfying the DB(k) safe harbor, such contributions are permitted, provided that the uniformity requirement is satisfied.[896]

5. Effect on §416 Top-Heavy Rules

A defined benefit plan and a defined contribution plan are treated as satisfying the §416 top-heavy rules for any plan year in which the plans are part of a DB(k) arrangement.[897] In contrast to the top-heavy relief provided to a §401(k)(12) or §401(k)(13) safe harbor plan, this appears to be a complete pass on the §416 top-heavy requirements. A §401(k)(12) or §401(k)(13) plan is only deemed to satisfy the top-heavy requirements to the extent that it does not provide contributions in excess of the minimum contributions necessary to satisfy the safe harbor requirements, but this limitation does not apply to a DB(k) arrangement. As a result, the top-heavy relief appears to apply even if additional contributions are provided under the qualified CODA portion of the DB(k) arrangement.

6. Plan Year Requirement

There is no explicit plan year requirement in §414(x). However, there is no explicit plan year requirement in either §401(k)(12) or §401(k)(13), and the IRS has implied one in those contexts, reasoning that relief from the nondiscrimination rules is only meaningful if provided on a plan year basis.[898] It seems likely, therefore, that the same plan year requirement applies to a DB(k) arrangement.

7. Notice Requirement

The automatic contribution feature of the CODA must comply with certain notice and election requirements. Specifically, each employee eligible to participate in the qualified CODA must receive a notice explaining the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to have the contributions made at a different rate.[899] Each eligible employee must also have a reasonable period of time after receipt of the notice and before the first elective contribution is made to make an election.[900] In addition, each eligible employee must be given an annual notice of the employee's rights and obligations under the arrangement, which must be provided within a reasonable period before any year.[901] The notice must be sufficiently accurate and comprehensive to apprise the employee of the employee's rights and obligations and must be written in a manner calculated to be understood by the average eligible employee.[902]

Practice Insight: Although the statute does not explicitly require any explanation of the non-automatic contribution aspects of the DB(k) plan, the IRS may interpret the statute to require an explanation of at least the material features of the defined contribution plan portion of the DB(k) arrangement. In this regard, the statutory language imposing a notice requirement in connection with the automatic contribution arrangement is comparable to the statutory language under §401(k)(12) and §401(k)(13).

E. Section 401(k)(11) — SIMPLE 401(k) Plans

A CODA that satisfies the provisions of §401(k)(11) for any plan year ("SIMPLE 401(k) plans") is deemed to satisfy the ADP and ACP tests.[903] SIMPLE 401(k) plans are also exempt from the top-heavy requirements of §416 for the year.[904] Thus, SIMPLE 401(k) plans are another type of designed-based safe harbor plan, but they are available only to smaller employers. In order to achieve the simplicity suggested by its name, SIMPLE 401(k) plans are more limited than other types of defined contributions plans in regard to the amount of employer and employee contributions and other plan-design alternatives.

SIMPLE 401(k) plans are distinct from SIMPLE IRAs, described in §408(p), which involve salary reduction contributions and effectively include CODAs. An employer may termi-

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vice distributions from age 62 to age 59½, a qualified plan is not required to provide for in-service distributions. If a qualified plan allowed for in-service distributions at age 62 prior to the changes made to §401(a)(36) by Pub. L. No. 116-94, it is not required to be amended to allow for in-service distribution at age 59½ after December 31, 2019. *See* Notice 2024-2, Q&A J-1 (extending plan amendment deadlines under the SECURE 2.0 Act of 2022); *see also* Notice 2020-68, Q&A F-1, *modified by* Notice 2022-33 (released before enactment of SECURE 2.0). For further discussion of phased retirement arrangements, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans.*

[894] §414(x)(2)(E).

[895] 2006 PPA Bluebook at 238.

[896] §414(x)(2)(C)(ii), §414(x)(2)(E).

[897] §414(x)(4).

[898] *See* IV.B.4., above.

[899] §414(x)(5)(B)(ii).

[900] §414(x)(5)(B)(ii).

[901] §414(x)(5)(B)(iii).

[902] §414(x)(5)(B) (flush language), referring to the specific notice requirements of §401(k)(12)(D)(i) and §401(k)(12)(D)(ii).

[903] §401(k)(11)(A), §401(m)(10); *see* Reg. §1.401(k)-4(a).

[904] §401(k)(11)(D)(ii); Reg. §1.401(k)-4(h).

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nate a SIMPLE IRA plan and adopt a SIMPLE §401(k) plan at any time during the year.[905] SIMPLE IRAs are discussed in 368 T.M., *SEPs and SIMPLEs.* See also 367 T.M., *IRAs.*

1. Eligible Employers

An employer is eligible to maintain a SIMPLE 401(k) plan if the employer has no more than 100 employees who earned $5,000 or more in compensation during the preceding calendar year.[906] For this purpose, compensation means all compensation subject to federal income tax withholding under §3401(a) plus elective deferrals under a §401(k) plan, §403(b) annuity arrangement, salary reduction SEP, or SIMPLE IRA plan, and amounts deferred under an eligible §457 plan.[907] In the case of a self-employed individual, "compensation" means net earnings from self-employment determined under §1402(a), before subtracting any contributions made under the SIMPLE 401(k) plan.[908]

Practice Insight: In identifying the number of employees, guidance issued under the SIMPLE IRA provisions of §408, which contains the same employer eligibility provisions, is instructive in determining whether an employer is eligible to maintain a SIMPLE 401(k) plan. As such, all employees employed at any time during the calendar year are taken into account, regardless of whether they are eligible to participate in the SIMPLE 401(k) plan, and regardless of whether they are otherwise excludible under the rules of §410(b)(3) or §410(b)(4).[909] Self-employed individuals receiving earned income from the employer during the year must also be counted.[910] In counting the employees of the employer, related employers are treated as a single employer to the extent required by §414(b), §414(c), and §414(m), and leased employees must be taken into account as employees.[911]

An employer that establishes and maintains a SIMPLE 401(k) plan for one or more years, and fails to be an "eligible employer" for any later year, is treated as an eligible employer for the two years following the last year the employer was an eligible employer.[912] In other words, an employer that previously maintained a SIMPLE 401(k) plan is treated as satisfying the "100-employee limitation" for the two calendar years immediately following the calendar year for which it last satisfied the 100-employee limitation. However, this grace period rule does not apply if the reason for the failure to be an eligible employer was due to any acquisition, disposition, or similar transaction involving an eligible employer, unless certain conditions are met.[913] Specifically, the employer must satisfy the following requirements of §410(b)(6)(C)(i) in order to remain an eligible employer for the two years following the acquisition, disposition, or similar transaction:[914] (1) the employer becomes or ceases to be a member of a group of employers aggregated under §414(b), §414(c), §414(m), or §414(o); (2) the plan satisfies §410(b) coverage requirements immediately before the change; and (3) coverage under the plan is not significantly changed during the transition period that begins on the date of the transaction and ends on the last day of the first plan year beginning after the date of the transaction.

2. Exclusive Plan Requirement

An employer generally cannot make contributions under a SIMPLE 401(k) plan for a calendar year if the employer, or a predecessor employer, maintains a qualified plan (other than the SIMPLE 401(k) plan) under which any of the SIMPLE 401(k) plan participants receives an allocation of contributions (in the case of a defined contribution plan) or has an increase in a benefit accrued or treated as an accrued benefit under §411(d)(6) (in the case of a defined benefit plan) at any time during the SIMPLE plan year.[915] However, an employer can make contributions under a SIMPLE 401(k) plan for a calendar year even though it maintains another qualified plan if participants in the SIMPLE plan benefit only from allocation of forfeitures under the other plan.[916] For this purpose, a "qualified plan" includes a plan qualified under §401(a) or §403(a), an annuity contract described in §403(b), a governmental plan (other than an eligible §457 plan), a simplified employee pension (SEP) under §408(k), a trust described in §501(c)(18), and a SIMPLE IRA described in §408(p).[917]

3. Contribution Requirements

Three contribution requirements must be satisfied by a SIMPLE plan.[918]

First, subject to §415 limitations, elective contributions must be permitted up to $10,000, as indexed in $500 increments.[919] For current and prior year adjusted dollar amounts, see the Worksheets of this Portfolio. Elective contributions may be expressed as a percentage of compensation.[920]

A SIMPLE 401(k) plan may be designed to allow catch-up contributions for participants who are age 50 or over, but the catch-up contribution limit is significantly lower than for other types of qualified plans.[921]For plan years beginning after December 31, 2023, elective contribution and catch-up contribu-

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[905] §408(p)(11), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §332(a), effective for plan years beginning after December 31, 2023. *See also* Notice 2024-2, Q&As G-1–7.

[906] §401(k)(11)(D)(i), §408(p)(2)(C)(i)(I); Reg. §1.401(k)-4(b)(1).

[907] Reg. §1.401(k)-4(e)(5).

[908] Reg. §1.401(k)-4(e)(5).

[909] Notice 98-4, Q&A B-1. *See* Notice 2024-2, Q&A E-3.

[910] Notice 98-4, Q&A B-1.

[911] Notice 98-4, Q&A B-5.

[912] §408(p)(2)(C)(i)(II); Reg. §1.401(k)-4(b)(2).

[913] §408(p)(2)(C)(i)(II); Reg. §1.401(k)-4(b)(2).

[914] Reg. §1.401(k)-4(b)(2).

[915] §401(k)(11)(C); Reg. §1.401(k)-4(c)(1).

[916] Reg. §1.401(k)-4(c)(2).

[917] §401(k)(11)(D)(i), §408(p)(2)(D)(ii); Reg. §1.401(k)-4(c)(1).

[918] §401(k)(11)(B)(i).

[919] §401(k)(11)(B)(i)(I); Reg. §1.401(k)-4(e)(2). *See* §408(p)(2)(E). When an employer elects to replace a SIMPLE IRA plan with a SIMPLE §401(k) plan mid-year, the total amount that may be contributed for the year may not exceed the weighted average of the salary reduction contribution and elective contribution limits for each plan. Notice 2024-2, Q&A G-6.

[920] §401(k)(11)(B)(i)(I).

[921] §414(v)(2)(B)(ii), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §117(b)(1)(A), effective for tax years beginning after December 31, 2023. For tax years beginning after December 31, 2024, there is a higher catch-up limit for individuals age 60, 61, 62, or 63 equal to the greater of 150% of the regular catch-up contribution in effect for 2025 or $5,000. §414(v)(2)(B)(ii), as amended by Pub. L. No. 117-328, Div. T, §109(b), effective for tax years beginning after December 31, 2024. *See* Prop. Reg. §1.414(v)-1(c)(2)(ii)(B), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025). According to the IRS, plans are not required to provide for a higher applicable dollar catch-up limit for participants at age 60 through age 63. REG-101268-24, 90 Fed. Reg. at 2649 n.6.

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tion limits increase by 10% for employers with less than 26 employees who received at least $5,000 of compensation from the employer for the preceding year.[922] For eligible employers with 26 or more employees who received at least $5,000 of compensation from the employer in the preceding year, the elective contribution and catch-up contribution limits will not increase unless the employer elects to provide a 3% nonelective contribution or a 4% employer matching contribution to all eligible employees.[923] The IRS applies guidance issued under the SIMPLE IRA provisions in determining the number of employees who received at least $5,000 of compensation for the preceding year. Thus, an eligible employer that grows will still be treated as having less than 26 employees for two years following the last year the employer had less than 26 employees.[924]

Note: The IRS, noting inconsistencies within the language in the clauses of §408(p)(2)(E), takes the position that an employer is eligible for the increased limits if, during the 3-taxable-year period preceding the first year that the employer maintained the SIMPLE 401(k) plan, the employer and any member of the employer's controlled group, and their predecessors did not establish or maintain a qualified plan, §403(a) annuity plan, or §403(b) plan under which contributions were made or benefits accrued for substantially the same employees that are eligible to participate in the SIMPLE plan. The increased limits apply automatically for employees of an eligible employer with 25 or fewer employees receiving at least $5,000 in the previous year. Other eligible employers must elect for the increases to apply.[925]

Practice Insight: An employer electing to apply (or revoke) the increased limits must take formal written action and properly document the election in the plan's records. Changes must be reflected in the plan terms. The employer must make the election before providing the annual notice of an employee's opportunity to enter into a salary reduction agreement or to modify a prior agreement. Employees must be notified, as discussed in IV.E.7., below. The employer should also notify the plan's financial institution and payroll provider, but is not required to notify the IRS.[926]

Second, the employer is required to make either matching or nonelective contributions. Matching contributions must be equal to 100% of the employee's elective contributions, not to exceed 3% of the employee's compensation for the year.[927] This 3% limit applies to the full calendar year, and not on a month-by-month or pay-period-by-pay-period basis.[928] Nonelective contributions must be equal to 2% of the employee's SIMPLE compensation for the full calendar year, but the employer may limit nonelective contributions to those eligible employees who received at least $5,000 of SIMPLE compensation from the employer for the entire plan year.[929] The 2% contribution must be made whether or not the eligible employee makes an elective contribution. An employer electing to use the 2% nonelective alternative for a calendar year must notify employees of that election within a reasonable period of time before the 60th day before the beginning of that year.[930] For purposes of both the 3% matching contribution and 2% nonelective contribution, "SIMPLE compensation" is defined in Reg. §1.401(k)-4(e)(5), as described in V.E.1., below, and is subject to the §401(a)(17) limitation.[931]

For plan years beginning after December 31, 2023, employers are permitted to make additional nonelective contributions of up to 10% of each eligible employee's SIMPLE compensation, up to a maximum of $5,000 per employee, as indexed for inflation.[932] This nonelective contribution may be made in addition to the 2% nonelective contribution or 3% matching contribution, and must be made on a uniform basis for all eligible employees. In addition, matching contributions may be made on account of "qualified student loan payments."[933]

Practice Insight: Unlike other safe harbor plans, there is only one definition of compensation that is permissible for SIMPLE 401(k) plans. This definition generally includes W-2 compensation and elective deferrals.

Third, no other types of employer or employee contributions, or contributions in excess of the amounts discussed above, may be made under the SIMPLE plan. An exception exists for eligible rollover contributions described in Reg. §1.402(c)-2(a).[934]

Practice Insight: An employer's deduction for contributions to a SIMPLE 401(k) plan is not limited to 25% of compensation, which is the deduction limitation that generally applies to employer contributions made to other types of qualified plans.[935]

4. *Vesting Requirement*

All contributions under a SIMPLE 401(k) plan must be nonforfeitable at all times.[936] This vesting requirement applies to the 2% nonelective contribution or 3% match, as the case may be, as well as the employee's elective contributions.

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[922] §408(p)(2)(E), as amended by Pub. L. No. 117-328, Div. T, §117(a); §401(k)(11)(E), added by Pub. L. No. 117-328, Div. T, §117(g)(2); §401(k)(11)(B)(i)(I), as amended by Pub. L. No. 117-328, Div. T, §117(g)(1). *See* Prop. Reg. §1.414(v)-1(c)(2)(ii)(C), REG-101268-24. *See also* General Explanation of the Tax Legislation Enacted in the 117th Congress, Staff of the Joint Committee on Taxation, JCS 1-23 (Dec. 2023) at 354–55.

[923] §408(p)(2)(B)(iii), added by Pub. L. No. 117-328, Div. T, §117(d); §408(p)(2)(C)(ii)(IV), added by Pub. L. No. 117-328, Div. T, §117(c)(2); §408(p)(2)(E), as amended by Pub. L. No. 117-328, Div. T, §117(a). *See* Prop. Reg. §1.414(v)-1(c)(2)(ii)(C), REG-101268-24. *See also* Notice 2024-2, Q&A E-2.

[924] Notice 2024-2, Q&A E-3 (applying rules of Notice 98-4, Q&A B-1). *But see* JCS 1-23 (Dec. 2023) at 354.

[925] Notice 2024-2, Q&As E-1–2.

[926] *See* Notice 2024-2, Q&As E-4–8.

[927] §401(k)(11)(B)(i)(II); Reg. §1.401(k)-4(e)(3).

[928] Reg. §1.401(k)-4(e)(3); *see* Rev. Proc. 97-9 (Model Amendment §3.2(a)).

[929] §401(k)(11)(B)(ii); Reg. §1.401(k)-4(e)(4); *see* Rev. Proc. 97-9 (Model Amendment §3.2(b)).

[930] §401(k)(11)(B)(ii).

[931] Reg. §1.401(k)-4(e)(5); *see* Rev. Proc. 97-9 (Model Amendment §2.1).

[932] §408(p)(2)(A)(iv), added by Pub. L. No. 117-328, Div. T, §116(a)(1); *see* §401(k)(11)(B)(i)(III), added by Pub. L. No. 117-328, Div. T, §116(b)(2). Compensation taken into account for this purpose is subject to the limits under §401(a)(17). *See* §408(p)(2)(A) (flush language).

[933] §408(p)(2)(F), added by Pub. L. No. 117-328, Div. T, §110(d). For a discussion of student loan repayments, see II.F.1.c., above.

[934] §401(k)(11)(B)(i)(IV), as redesignated by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §116(b)(2); Reg. §1.401(k)-4(e)(1).

[935] Section 404(a)(3)(A)(i) specifically provides that an employer's deduction for contributions to a qualified plan is limited to the greater of 25% of compensation or the amount contributed to a SIMPLE plan.

[936] §401(k)(11)(A)(iii), §408(p)(3); Reg. §1.401(k)-4(f).

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5. Plan Year Requirement

The plan year of the SIMPLE 401(k) plan must be a calendar year.[937] In addition, it must generally be the whole calendar year. That is, a SIMPLE plan can be established on January 1 and terminated on December 31, except that if the employer did not previously maintain a SIMPLE plan, the establishment date can be as late as October 1 (or as soon as administratively feasible if the employer comes into existence after October 1).[938]

6. Salary Reduction Election

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.[939] For each subsequent plan year, each eligible employee must be permitted to make or modify his or her cash or deferred election during the 60-day period immediately preceding such plan year.[940] In addition, an eligible employee must be permitted to terminate his or her cash or deferred election at any time. If an employee terminates the 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.[941]

7. Notice Requirement

An employer that maintains a SIMPLE plan must notify each employee eligible to participate, at or within a reasonable period of time before the beginning of the 60-day election period, of the rules for electing to participate.[942] The notice must state whether the employer will make matching contributions or nonelective contributions as described in IV.E.3., above.

8. Other Qualification Requirements

Except as provided in §401(k)(11) and discussed above, all other qualification requirements of the Code continue to apply to a SIMPLE 401(k) plan, including the contribution limits of §415, the compensation limit of §401(a)(17), the distribution restrictions of §401(k)(2)(B), and the prohibition against governmental §401(k) plans (other than plans grandfathered from §401(k)(4)(B)).[943]

9. Model Amendment

The IRS has published a model amendment that may be used to assist employers in adopting a 401(k) plan that contains SIMPLE provisions. The amendment must be adopted on a word-for-word basis, and may be adopted as part of a new or existing §401(k) plan.[944] If the model amendment is used, its provisions supersede any other, inconsistent plan provision.[945] For example, if a plan contains a provision that limits an employee's salary reduction contributions for a year to a percentage that results in amounts less than the limit for SIMPLE IRAs under §408(p)(2) ($10,000, as indexed), the salary reduction contribution provision of the model amendment permitting yearly contributions up to that limit will govern.

The model amendment may be used by individually designed plans that contain CODA provisions and sponsors of master and prototype, regional prototype, and volume submitter specimen plans that have received favorable opinion, notification, advisory, or determination letters.[946] If a sponsor to whom the model amendment is available adopts the model amendment, neither application to the IRS nor a user fee is required. The IRS will not issue new opinion, notification, advisory, or determination letters for plans that are amended solely to add the model amendment.[947]

A new §401(k) plan containing the model amendment may be made effective as of any date, but no later than October 1 of the year in which it is adopted.[948] For existing plans, the model amendment must generally be effective as of the following January 1.[949]

The model amendment also contains a model revocation clause which permits employers to revoke the SIMPLE §401(k) provisions without terminating the plan. The revocation clause should be executed only if the employer wants to revert to the plan provisions that apply in the absence of SIMPLE §401(k) provisions. The revocation may be adopted on any date, but may only become effective on the first day of the calendar year following the date of adoption.[950]

10. Automatic Enrollment Tax Credit for Small Employers

A tax credit of up to $500 per year is available to any eligible employer that includes automatic enrollment in its qualified employer plans (e.g., a §401(k) plan) and that had no more than 100 employees who received at least $5,000 of compensation from the employer for the preceding year.[951] Employers may claim the credit for (1) startup costs for a §401(k) plan that includes automatic enrollment or (2) costs for converting an existing plan to an automatic enrollment design. The credit is effective for tax years beginning after December 31, 2019, and is available for three years. For purposes of this credit, an eligible automatic contribution arrangement is defined under §414(w)(3), which is discussed in VII.B., below.

An eligible employer may receive a credit for tax years only during a single three-year credit period that begins when the employer first includes an eligible automatic contribution arrangement (EACA) in any qualified employer plan.[952] To be eligible for the §45T credit for the second or third tax years of an eligible employer's three-year credit period that begins

[937] §401(k)(11)(D)(i), §408(p)(6)(C); Reg. §1.401(k)-4(g).
[938] Reg. §1.401(k)-4(g).
[939] Reg. §1.401(k)-4(d)(2)(i).
[940] Reg. §1.401(k)-4(d)(2)(ii).
[941] Reg. §1.401(k)-4(d)(2)(iii).
[942] §401(k)(11)(B)(iii)(II); Reg. §1.401(k)-4(d)(3).
[943] Rev. Proc. 97-9, §2.06.
[944] Rev. Proc. 97-9, §1.01, §2.08, §4.01.
[945] Rev. Proc. 97-9, §2.07.
[946] Rev. Proc. 97-9, §4.
[947] Rev. Proc. 97-9, §4.
[948] Rev. Proc. 97-9, §2.08.
[949] Rev. Proc. 97-9, §2.08.
[950] Rev. Proc. 97-9, §5.
[951] §45T, added by Pub. L. No. 116-94, Div. O, §105(a), effective for tax years beginning after December 31, 2019. *See* §38(b)(33), added by Pub. L. No. 116-94, Div. O, §105(b). For purposes of this credit, an eligible employer is defined by reference to §408(p)(2)(C)(i) and a qualified employer plan is defined by reference to §4972(d).
[952] Notice 2020-68, Q&A A-1.

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when the eligible employer first includes an EACA in a qualified employer plan, the eligible employer must include the same EACA in the same plan in that second or third tax year.[953]

Practice Insight: Taxpayers may need to amend the terms of their plans to reflect the eligible automatic contribution arrangement before they are eligible to take the credit.[954]

F. Section 401(k)(16) — Starter 401(k) Plans

Employers without an established retirement plan may offer a deferral-only starter §401(k) plan.[955] Employers that choose to offer a starter §401(k) plan must automatically enroll all eligible employees satisfying the minimum age and service requirements.[956] A starter §401(k) plan generally requires that employees be enrolled in the plan at a compensation deferral rate ranging from 3% to 15%.[957] Employees may choose to opt-out of the automatic deferrals by making an affirmative election to (i) not have the contributions made, or (ii) make elective contributions at a different rate that is specified in the affirmative election.[958]

[953] Notice 2020-68, Q&A A-2.

[954] *See* §45T(b)(2).

[955] §401(k)(16), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §121(a), effective for plan years beginning after December 31, 2023.

[956] §401(k)(16)(C), §401(k)(16)(F).

[957] §401(k)(16)(C)(iii).

[958] §401(k)(16)(C)(ii).

Elective contributions by employees are the only contributions permitted for starter §401(k) plans.[959] Therefore, employers are prohibited from making contributions to starter §401(k) plans.

The annual contribution limit for employee elective contributions is $6,000, as adjusted for inflation.[960] The contribution limit is increased to allow catch-up contributions from employees that have attained age 50 before the close of the tax year.

In addition to meeting these automatic deferral requirements and contribution limitations, a starter §401(k) deferral-only arrangement must satisfy the notice requirement for a §401(k)(13) safe harbor plan.[961]

Practice Insight: The IRS has indicated that satisfaction of the automatic enrollment and contribution escalation provisions of §414A apply to a starter §401(k) plan for plan years beginning after December 31, 2024.[962] Thus, unless an employer that is offering a starter §401(k) plan meets one of the exceptions to that requirement (e.g., new business or small employer), it may be advisable for an employer to comply with the automatic enrollment and contribution escalation requirements before 2025 to avoid having to amend the plan and change its administrative procedures to reflect the automatic enrollment and contribution escalation requirements.

[959] §401(k)(16)(D)(i)(I).

[960] §401(k)(16)(D)(i)(II), §401(k)(16)(D)(ii).

[961] §401(k)(16)(B). The notice requirements under §401(k)(13)(E) are discussed in IV.C.4., above.

[962] Notice 2024-2, Q&A A-6. For discussion of §414A, see II.G., above.

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V. Roth Contributions

A Roth contribution program is an optional feature of a §401(k) plan that permits an employee to elect to make after-tax contributions in lieu of all or a portion of the pre-tax elective deferrals the employee is otherwise eligible to make under the plan.[963]

A Roth contribution is any elective deferral that an employee designates as not excludible from income.[964] Thus, Roth contributions are made from after-tax income. Roth contributions must be maintained by the plan in a separate account called a designated Roth account.[965] A qualified distribution from a designated Roth account is excludible from gross income.[966] If the distribution is not a qualified distribution, the distribution is included in the distributee's gross income except to the extent allocable to investment in the contract under §72.[967]

Practice Insight: The primary advantage to Roth contributions is that, so long as certain parameters are met, distributions are tax-free, meaning that while the employee paid taxes on the money used to fund the contribution, generally the employee never pays taxes on the earnings.

A. Comparison of a Roth Contribution Program Under a §401(k) Plan and a Roth IRA

A Roth contribution program under a §401(k) plan is similar to a Roth IRA.[968] Like contributions to Roth IRAs, designated Roth contributions to a §401(k) plan are made from after-tax income and, like distributions from Roth IRAs, qualifying distributions from a §401(k) plan that are attributable to designated Roth contributions are tax-free. Further, upon distribution from the §401(k) plan, amounts attributable to a designated Roth account generally can be rolled over tax-free to a Roth IRA.

There are, however, differences between a Roth contribution program under a §401(k) plan and a Roth IRA. First, unlike Roth IRAs, there is no income limit on eligibility to make designated Roth contributions to a §401(k) plan.[969] Second, a traditional IRA may be converted to a Roth IRA but a pre-tax elective deferral account (or other pre-tax account) may not be converted to a designated Roth account.[970] Third, special ordering rules apply to distributions from a Roth IRA.[971] These rules do not apply to a distribution from a designated Roth account and, instead, the general distribution rules of §72 apply if a distribution from a Roth account is a nonqualified distribution.[972] Notably, employees who make designated Roth contributions to a §401(k) plan can also make Roth IRA contributions, if otherwise eligible under the general Roth IRA rules.

[963] §402A. *See* Reg. §1.402A-1, Q&A-1.
[964] §402A(c)(1).
[965] §402A(b)(2).
[966] §402A(d)(1).
[967] Reg. §1.402A-1, Q&A-3.
[968] For further discussion of Roth IRAs, see 367 T.M., *IRAs*.
[969] §408A(c)(3).
[970] §408A(d)(3)(C).
[971] §408A(d)(4)(B).
[972] Reg. §1.402A-1, Q&A-3.

B. Roth Contribution Program Plan Design

A plan is not obligated to offer a qualified Roth contribution program.[973] Rather, it is a matter of plan design. However, a plan cannot offer only Roth contributions.[974] A plan that offers a qualified Roth contribution program must also offer employees the right to make pre-tax elective deferrals.[975] It is permissible for an employee to make both pre-tax elective deferrals and Roth elective deferrals in a single plan year.[976]

Note: Plans that do not permit Roth contributions need to be amended to provide for Roth contributions for tax years beginning on or after January 1, 2024, at least for catch-up contributions. This is because participants with more than $145,000 (as adjusted after 2024) in wages for the preceding calendar year who elect to make any catch-up contributions will be required to make the catch-up contributions as Roth contributions, as discussed in VIII.G., below.

Designated Roth contributions are a form of elective deferral.[977] As a result, for example, designated Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and the distribution restrictions, and, therefore, must be immediately nonforfeitable and are subject to the §401(k) elective deferral distribution restrictions (e.g., distribution may not be made before age 59½ in circumstances other than disability or severance from employment). Further, a designated Roth contribution is taken into account as an employer contribution to the same extent as any other elective deferral, including for purposes of §402(g) (elective deferral limit), §415 (plan limits), and §416 (top-heavy rules).[978]

For tax years beginning before January 1, 2024, designated Roth contributions were subject to the required minimum distributions rules of §401(a)(9) to the same extent as pre-tax elective deferrals.[979] Note that this was in contrast to the treatment of Roth IRAs, which are generally exempt from the lifetime required minimum distribution rules.[980] However, for tax years beginning on or after January 1, 2024, Roth-designated accounts are exempt from the pre-death required minimum distribution rules of §401(a)(9).[981]

[973] Reg. §1.401(k)-1(f)(1) (noting that contributions may only be designated Roth contributions "to the extent permitted under the plan").
[974] Reg. §1.401(k)-1(f)(1) (defining a Roth contribution by reference to the extent to which pre-tax elective contributions may be made). *See also* T.D. 9237, 71 Fed. Reg. 6, 7 (Jan. 3, 2006) (rejecting suggestions that an employer sponsoring a qualified CODA be permitted to only offer designated Roth contributions).
[975] Reg. §1.401(k)-1(f)(1)(i).
[976] Reg. §1.401(k)-1(f)(1)(i).
[977] Reg. §1.402(g)-1(b)(5).
[978] Reg. §1.401(k)-1(f)(4).
[979] *See* Reg. §1.401(k)-1(f)(4). *See also* §402A(d)(5), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §325(a). For a discussion of the required minimum distribution rules, see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*.
[980] §408A(c)(4)(A), as redesignated by the SECURE Act of 2019, Pub. L. No. 116-94, Div. O, §107(c). This legislation is also referred to as "SECURE 1.0" following the enactment of the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, on December 29, 2022.
[981] §402A(d)(5), added by the SECURE 2.0 Act, Pub. L. No. 117-328, Div. T, §325(a). *See* Reg. §1.401(a)(9)-3(a)(2), added by T.D. 10001, 89 Fed. Reg. 58,886 (July 19, 2024).

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Practice Insight: The change made by the SECURE 2.0 Act exempting Roth-designated accounts from the pre-death minimum distribution rules does not apply to distributions which are required for years beginning before January 1, 2024, but are permitted to be paid on or after such date.[982]

Although designated Roth contributions are after-tax contributions, Roth contributions are not included with traditional after-tax employee contributions for purposes of the ACP test.[983] Designated Roth contributions are instead taken into account with other elective deferrals to the plan in applying the ADP test.[984] Designated Roth contributions are also permitted features of a §401(k)(12) safe harbor plan and a §401(k)(13) safe harbor plan.

Practice Insight: The addition of a qualified Roth contribution program generally does not affect nondiscrimination testing since such contributions presumably replace pre-tax elective deferrals that were previously being taken into account in applying the ADP test.

A Roth contribution feature may be offered only to certain participants in a §401(k) plan. However, a Roth contribution feature is treated as a benefit, right, or feature that is subject to nondiscrimination testing under §401(a)(4).[985] As a result, eligibility to make designated Roth contributions must be available on a nondiscriminatory basis.

1. Roth Contribution Elections

An employee must have an effective opportunity to make or change an election to make designated Roth contributions at least once a year.[986]

Practice Insight: This presumably includes an effective opportunity to choose between pre-tax and Roth contributions as well as an effective opportunity to make Roth contributions.

A plan that offers a qualified Roth contribution program must specify the default rule in the event that a participant fails to make an affirmative election as to whether the contributions are pre-tax elective deferrals or designated Roth contributions.[987] Defaulted Roth contributions are still subject to the requirement that Roth designations are irrevocable.[988]

In the case of plan participants who are subject to the Roth catch-up contribution requirement because of their wages from the employer in the preceding year (see VIII.G.), a proposed rule issued in January 2025 would permit a plan to treat the participant's election to make catch-up contributions on a pre-tax basis as an election to make catch-up contributions as designated Roth contributions. A plan would be permitted to provide, for taxable years beginning after December 31, 2023, that a participant who must make catch-up contributions as Roth contributions is deemed to have irrevocably designated any catch-up contributions as designated Roth contributions.[989] The plan could provide for a deemed Roth catch-up election without regard to whether it requires separate elections for elective deferrals that are not catch-up contributions and for additional elective deferrals that are catch-up contributions, as long as the participant would have an effective opportunity to make a new election that is different than the deemed election.[990]

2. Use of Roth Contributions with an Automatic Contribution Arrangement

There is no barrier to the use of designated Roth contributions as part of an automatic contribution arrangement. The IRS has expressly indicated that an automatic contribution arrangement may provide for designated Roth contributions, and there does not appear to be any barrier to the use of designated Roth contributions in a §401(k)(13) qualified automatic contribution arrangement.[991]

3. Plan Provisions for Roth Contributions

A §401(k) plan that provides for a Roth contribution feature must provide so in the plan document. The IRS has indicated, however, that the special timing rule for qualified CODAs, which generally requires that a plan amendment reflecting a CODA be in place prior to the first elective deferral,[992] does not apply to a Roth contribution feature.[993] Rather, the general timing rule for discretionary plan amendments, which is the end of the plan year in which the amendment is effective, applies.[994] This timing rule does not modify the general rule that a plan amendment must be in place prior to implementation of a qualified CODA. It applies only with respect to the addition of a Roth contribution feature to an existing qualified CODA. The IRS has published a model amendment.[995]

4. Employer Roth Contributions

Effective for contributions made to a plan on or after December 30, 2022, an employer may provide employees with the option of receiving all or a portion of matching and nonelective contributions as designated Roth contributions.[996] These contributions are includible in the employee's gross income for the

[982] Pub. L. No. 117-328, Div. T, §325(b)(2).

[983] Reg. §1.401(k)-1(f)(4).

[984] Reg. §1.401(k)-1(f)(4).

[985] Reg. §1.401(k)-1(a)(4)(iv)(B). For further discussion of nondiscrimination testing under §401(a)(4), see 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans.*

[986] Reg. §1.401(k)-1(f)(5)(i).

[987] Reg. §1.401(k)-1(f)(5)(ii)(A).

[988] Reg. §1.401(k)-1(f)(5)(ii)(B).

[989] *See* Prop. Reg. §1.401(k)-1(f)(5)(iii), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025), proposed to apply with respect to contributions in taxable years beginning more than six months after final regulations adding Reg. §1.414(v)-2 (for catch-up contributions that must be designated Roth contributions under §414(v)(7)) are issued. For plans maintained pursuant to collective bargaining agreements, the change would apply with respect to contributions in taxable years beginning after the later of the first taxable year described above or the first taxable year that begins after the date on which the last collective bargaining agreement related to the plan that is in effect on December 31, 2025, terminates (without regard to extensions).

[990] Prop. Reg. §1.401(k)-1(f)(5)(iv); REG-101268-24, 90 Fed. Reg. at 2648 (preamble). *See* §414(v)(7)(D). For discussion of what would constitute an effective opportunity to make an election, see II.B.1.c., above.

[991] Reg. §1.401(k)-1(f)(5)(ii).

[992] Reg. §1.401(k)-1(a)(3)(iii).

[993] Notice 2006-44.

[994] Notice 2006-44. The IRS has rephrased this deadline as the end of the plan year in which the discretionary amendment is "operationally put into effect." For a general discussion of plan amendment deadlines, see 360 T.M., *Qualified Plans — IRS Determination Letter Procedures.*

[995] Notice 2006-44.

[996] §402A(a)(2), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §604(a). *See* §402A(c)(1) ("designated Roth contribution"), as amended by Pub. L. No. 117-328, Div. T, §604(c), §402A(f)(3) ("matching contribution"), added by Pub. L. No. 117-328, Div. T, §604(d), applicable to contributions made after the December 29, 2022, date of enactment. *See* Notice 2024-2, Q&As L-1–11.

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tax year in which the contributions are allocated to the employee's account, and must be 100% vested when made.[997] The total amount of designated Roth matching and nonelective contributions allocated to the employee's account for the tax year are reported on Form 1099-R.[998]

Designated Roth matching and nonelective contributions are excluded from wages for purposes of federal income tax withholding, FICA, and FUTA.[999]

5. *Pension-Linked Emergency Savings Accounts*

For plan years beginning on or after January 1, 2024, an employer may establish a pension-linked emergency savings account ("PLESA"), allowing non-highly compensated employees ("NHCE") to make contributions designed to be withdrawn to address short-term emergency needs.[1000] An employee who becomes a highly compensated employee ("HCE") after contributing to a PLESA is no longer permitted to contribute to the PLESA, but retains the right to make withdrawals from the PLESA.[1001]

A PLESA is treated as a designated Roth account and contributions to a PLESA are made on an after-tax basis.[1002] Contributions and earnings on those contributions must be accounted for separately.[1003] PLESA contributions must be held as cash in an interest-bearing deposit account or in a state or federally regulated investment product.[1004] Employers must report contributions to a PLESA, along with any other designated Roth contributions, on Form W-2.

An employer is prohibited from imposing a minimum amount for opening a PLESA and a minimum balance amount needed to maintain a PLESA.[1005] However, an employer may establish a limit for employee contributions to PLESAs up to the statutory limit of $2,500, as indexed.[1006] Once an employee reaches the contribution limit, additional contributions designated for the PLESA may be directed to the employee's Roth account, or may be paused until the PLESA balance falls below the limit.[1007] If excess deferrals under §402(g)(2)(A) are distributed to a participant, such distributions must first come from the participant's PLESA account to the extent contributions were made to the PLESA during the applicable tax year.[1008] PLESA contributions are treated as designated Roth contributions for purposes of the limits under §402(g).[1009]

An employer who establishes a PLESA program may establish an automatic contribution arrangement, automatically opting employees into PLESA contribution arrangements at no more than 3% of an employee's compensation.[1010] If an employer establishes an automatic contribution arrangement, the employer must provide notification and allow employees to opt-out of the arrangement or opt to make contributions at a different rate.[1011] An employer may establish reasonable procedures to limit the frequency and amount of contributions to a PLESA in order to prevent abuse.[1012]

Notice 2024-22 contains guidance for the discretionary anti-abuse rules, including a nonexhaustive list of anti-abuse procedures that are not reasonable and are prohibited from being used to limit the frequency or amount of matching contributions made to employees.[1013] Only reasonable anti-abuse procedures that balance the interests of participants in using the PLESA for its intended purpose with the interests of plan sponsors in preventing manipulation of the plan's matching contribution rules are permitted. The IRS considers the following to be unreasonable for a plan sponsor to implement: (1) forfeiture of matching contributions; (2) suspension of participant contributions to the PLESA; and (3) suspension of matching contributions on participant contributions to the underlying defined contribution plan.[1014]

Note: The IRS takes the position that Rev. Rul. 74-55 and Rev. Rul. 74-56 do not apply to PLESAs, regardless of whether matching contributions are made.[1015] These rulings address circumstances in which a profit-sharing plan provision that permits participant withdrawals of their contributions could reasonably be expected to result in the manipulation of the formula allocating employer contributions and, thus, violate the requirement that a qualified plan provide a definite predetermined allocation formula.

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[997] *See* §402A(a)(2), §402A(a)(3), added by Pub. L. No. 117-328, Div. T, §604(a), §402A(f)(3). *See also* Notice 2024-2, Q&As L-2–3.

[998] Notice 2024-2, Q&A L-9.

[999] *See* Notice 2024-2, Q&As L-5–6. For further discussion of withholding, FICA, and FUTA, see 392 T.M., *Withholding, Social Security, and Unemployment Taxes on Compensation.*

[1000] §402A(e), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §127(e); ERISA §801, added by Pub. L. No. 117-328, Div. T, §127(b)(1). *See* DOL, Frequently Asked Questions: Pension-Linked Emergency Savings Accounts ("FAQs: PLESAs"), https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/faqs (released January 17, 2024).

[1001] §402A(e)(2)(B); ERISA §801(b)(2).

[1002] §402A(e)(1)(A)(i).

[1003] ERISA §801(c)(2)(A). PLESA funds may be held in a segregated omnibus account. DOL, FAQs: PLESAs, Q&A-10. An employer must remit amounts withheld from wages to the PLESA as of the earliest date that contributions can reasonably be segregated from the employer's general assets, but not later that the 15th business day of the month following the month in which the contribution is either withheld or received by the employer. *See* 29 C.F.R. §2510.3-102; DOL, FAQs: PLESAs, Q&A-9.

[1004] ERISA §801(c)(1)(A)(iii). Investment products must be designed to preserve employees' contributions while also providing liquidity and a reasonable rate of return. Plan fiduciaries may select any prudent investment product that satisfies the statutory criteria. This generally would not include the plan's qualified default investment alternative, unless it is a limited duration QDIA, or products containing liquidity constraints, such as surrender charges at the participant or plan level. DOL, FAQs: PLESAs, Q&As-14 and -15.

[1005] ERISA §801(c)(1)(A)(i). According to the DOL, the imposition of fees for falling below a specified account balance set would violate this provision, but reasonable practices (e.g., requiring whole dollar PLESA contributions) would not. DOL, FAQs: PLESAs, Q&A-5.

[1006] §402A(e)(3)(A); ERISA §801(d)(1)(A). The plan may choose to either include or exclude earnings on the participant's contributions, as long as the portion of the account balance attributable to participant contributions does not exceed the statutory limit. DOL, FAQs: PLESAs, Q&A-7.

[1007] §402A(e)(3)(B); ERISA §801(d)(1)(B).

[1008] §402A(e)(9).

[1009] DOL, FAQs: PLESAs, Q&A-6.

[1010] §402A(e)(4)(A); ERISA §801(d)(2)(A). The employer may amend such rate no more than once a year. §402A(e)(4)(B)(ii); ERISA §801(d)(2)(B)(ii). The ERISA PLESA provisions supersede any state law that would directly or indirectly prohibit or restrict the use of an automatic contribution arrangement. ERISA §802, added by Pub. L. No. 117-328, Div. T, §127(b)(1).

[1011] §402A(e)(4)(A)(i), §402A(e)(4)(A)(ii); ERISA §801(d)(2)(A)(i), §801(d)(2)(A)(ii).

[1012] §402A(e)(12); ERISA §801(f).

[1013] *See* Notice 2024-22, §III (guidance under §402A(e)(12) regarding reasonable anti-abuse procedures).

[1014] Notice 2024-22, §III.B.

[1015] Notice 2024-22, §IV.

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An employer who establishes a PLESA program must furnish a notice to participants in the plan describing:[1016]

- the purpose of the PLESA;
- the limits and tax treatment of PLESA contributions;
- any PLESA fees, expenses, restrictions, or charges under the plan;[1017]
- procedures for electing to make contributions to the PLESA, opting out of automatic contributions, changing contribution rates, and making withdrawals;
- the amount of the intended contribution to the PLESA, if applicable;
- the amount in the participant's PLESA and the rate the participant has made contributions;
- the designated investment option for amounts contributed to the PLESA;[1018]
- the withdrawal and rollover options available for employees who terminate employment with a PLESA balance;[1019] and
- the rights and restrictions on employees who became HCEs after contributing to the PLESA.

The notice must be furnished at least 30 days, but not more than 90 days, prior to the date of (i) the first contribution to the PLESA, or (ii) any change in the PLESA contribution rate.[1020] The notice may be included with other notices issued to employees.[1021]

Practice Insight: Pension benefit statements under ERISA §105 and participant-directed individual account plan disclosures furnished under 29 C.F.R. §2550.404a-5 are not required to address a plan's PLESA feature, but only if the employer satisfies the PLESA notice requirements discussed above.[1022]

An employee must be allowed to make a withdrawal from the PLESA at least once per month and at the employee's discretion.[1023] The employee does not need to demonstrate or certify the existence of an emergency.[1024] Distributions from a PLESA are treated as qualified Roth distributions and satisfy the requirements of §401(k)(2)(B)(i).[1025] The first four withdrawals from an employee's PLESA in a given plan year may not be subject to any fees or charges based solely on the basis of the withdrawal, but subsequent withdrawals within the same plan year may be subject to reasonable fees or charges.[1026] Distributions from a PLESA, other than for a termination as discussed below, are not treated as eligible rollover distributions for purposes of the direct rollover requirement of §401(a)(31), are not subject to mandatory 20% withholding under §3405(c), and are not subject to the rollover notice requirements of §402(f).[1027]

Practice Insight: To avoid restricting employees from replenishing funds following a withdrawal, an employer may not impose an annual limit on PLESA contributions other than the account balance limit.[1028]

If an employer makes matching contributions under the plan, the employer is also required to make matching contributions based on PLESA contributions.[1029] Employer matching contributions are not made to employee PLESA accounts, but rather to the individual's matching account under the plan.[1030] For any limitations on matching contributions under the plan, the matching contributions must first be treated as attributable to the elective deferrals rather than the PLESA contributions.[1031]

When a participant terminates employment, or if the plan terminates the PLESA feature, the plan must allow the participant to elect either (i) a rollover of all or part of the remaining PLESA balance to another designated Roth account under the plan, or (ii) a withdrawal of any PLESA balance that the employee does not roll over.[1032] If the participant elected transfer to another designated Roth account under the plan, the distribution generally is treated as an eligible rollover distribution.[1033]

An employer may terminate the PLESA feature of an individual account plan at any time.[1034]

C. Designation of Roth Contributions

There are two aspects to the designation of a Roth contribution. First, the employee must irrevocably designate an elective deferral as a Roth contribution.[1035] Second, the employer must treat the contribution as not excludible from income.[1036]

With respect to the irrevocable designation as a Roth contribution, the designation may not be retroactive.[1037] Thus, an employee may only convert previously contributed pre-tax elective deferrals to Roth contributions if the plan allows for in-plan Roth rollovers (discussed below). The amount designated as a Roth contribution cannot exceed the maximum amount of elective deferrals which the employee may contribute to the

[1016] §402A(e)(5); ERISA §801(d)(3).

[1017] Employers may impose reasonable fees on PLESAs for general account administration. *See* DOL, FAQs: PLESAs, Q&A-16.

[1018] *See* ERISA §801(c)(1)(A)(iii).

[1019] *See* §402A(e)(8); ERISA §801(e).

[1020] §402A(e)(5)(A); ERISA §801(d)(3)(A).

[1021] §402A(e)(5)(C); ERISA §801(d)(3)(C). *See* DOL, FAQs: PLESAs, Q&A-18 (restating DOL's position on consolidation of notices; indicating satisfaction of SECURE 2.0 Act §341's directive to adopt regulations where a plan may, but is not required to, consolidate two or more notices required by ERISA).

[1022] *See* DOL, FAQs: PLESAs, Q&A-19.

[1023] §402A(e)(7)(A); ERISA §801(c)(1)(A)(ii). Although authorized by ERISA §801(c)(1)(B), the DOL has indicated an intent to not impose reasonable restrictions on how PLESA distributions are made. DOL, FAQs: PLESAs, Q&A-13.

[1024] *See* DOL, FAQs: PLESAs, Q&A-11.

[1025] §402A(e)(7)(B).

[1026] ERISA §801(c)(1)(C). Reasonable reimbursement fees imposed for the incidental costs of handling of paper checks for payment of a withdrawal would be a reasonable fee or charge permitted after the fourth withdrawal in a plan year. DOL, FAQs: PLESAs, Q&A-12.

[1027] §402A(e)(10). Such distributions at termination are not eligible rollover distributions for purposes of the mandatory distribution rule under §401(a)(31)(B). §402A(e)(10)(B).

[1028] *See* ERISA §801(d)(1); DOL, FAQs: PLESAs, Q&A-8.

[1029] §402A(e)(6); ERISA §801(d)(4).

[1030] §402A(e)(6)(A); ERISA §801(d)(4)(A). For this purpose, matching contributions are defined under §401(m)(4). §402A(e)(6)(C); ERISA §801(d)(4)(C).

[1031] §402A(e)(6)(B); ERISA §801(d)(4)(B).

[1032] §402A(e)(8)(A); ERISA §801(e).

[1033] §402A(e)(10)(B). It is not an eligible rollover distribution for purposes of the mandatory distribution rule under §401(a)(31)(B), however.

[1034] ERISA §801(c)(2)(B). *See* §402A(e)(11).

[1035] §402A(c)(1)(B); Reg. §1.401(k)-1(f)(1)(i).

[1036] Reg. §1.401(k)-1(f)(1)(ii).

[1037] Reg. §1.401(k)-1(f)(1)(i).

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plan for the year, reduced by the amount of any pre-tax elective deferrals for the year.[1038] Thus, the annual dollar limit on the amount a participant can designate as a Roth contribution is the §402(g) annual limit on elective deferrals, reduced by the participant's traditional pre-tax elective deferrals. It is permissible, however, to designate §414(v) catch-up contributions as Roth contributions.[1039]Effective for tax years beginning on or after January 1, 2024, it is mandatory to designate catch-up contributions as Roth contributions for participants with more than $145,000 (as adjusted after 2024) in wages for the preceding calendar year, as discussed in VIII.G.

The requirement that the employer treat the contribution as not excludible from income ordinarily means taking the contribution into account for income tax withholding purposes.[1040] However, it is possible to make a Roth contribution out of income that would otherwise be excludible from gross income if paid directly to the employee, for example, income that is nontaxable by reason of a statutory exclusion (e.g., certain amounts received through accident or health insurance), provided that the employee would be entitled to treat the amount as investment in the contract under §72(f)(2).[1041] In such case, it is not clear that the employer must take any special steps to treat the Roth contribution as not excludible from income. In the case of a plan covering participants who could elect the foreign earned income exclusion under §911, the IRS ruled that the plan may permit participants to make qualified Roth contributions to the plan from their wages without regard to whether participants later elect the exclusion because the plan treated Roth contributions as includible in participants' gross income at the time the contribution was made.[1042]

For self-employed persons, a Roth contribution is treated as not excludible from income only if the individual does not claim a deduction for such amount.[1043] This provision, however, does not authorize retroactive designations since the elective deferrals generally must be designated as Roth contributions at the time of the deferral.

Rollover contributions of any payment or distribution from a designated Roth account under another plan are permitted, provided that the receiving plan allows for designated Roth contributions.[1044] A plan may not accept rollovers of Roth contributions unless the plan permits designated Roth contributions.[1045]

Practice Insight: Presumably this rule reflects the IRS view that the applicable requirements are less likely to be satisfied where the plan is not independently structured to satisfy the applicable Roth requirements. The regulations are not clear on whether a plan that discontinues its designated Roth contribution feature for future deferrals (but continues to hold amounts attributable to designated Roth contributions) may accept Roth rollovers, but a conservative reading would suggest that it cannot.

[1038] §402A(c)(2).
[1039] Reg. §1.401(k)-1(f)(4)(i); T.D. 9237, 71 Fed. Reg. at 8.
[1040] Reg. §1.401(k)-1(f)(2).
[1041] Reg. §1.401(k)-1(f)(2).
[1042] PLR 202302007.
[1043] Reg. §1.401(k)-1(f)(2).
[1044] Reg. §1.401(k)-1(f)(4)(ii), §1.402A-1, Q&A-5.
[1045] Reg. §1.401(k)-1(f)(4)(ii), §1.402A-1, Q&A-5.

D. Roth Contribution Separate Account Requirement

A qualified Roth contribution program must establish separate accounts for the designated Roth contributions and any earnings and losses allocable thereto.[1046] In addition, the plan must maintain separate recordkeeping with respect to each such account.[1047] Thus, contributions and withdrawals of designated Roth contributions must be credited and debited to a designated Roth account maintained for the employee and the plan must maintain a record of the employee's investment in the contract, i.e., the designated Roth contributions that have not been distributed.[1048] Gains, losses, and other credits or charges must be separately allocated on a reasonable and consistent basis to the designated Roth account and other accounts under the plan.[1049] Forfeitures may not be allocated to the designated Roth account and no contributions other than designated Roth contributions and rollovers attributable to designated Roth contributions may be allocated to the account.[1050] The separate accounting requirement applies at the time the designated Roth contribution is made to the plan and must continue to apply until the designated Roth contribution is fully distributed.[1051]

Any transaction or accounting methodology involving an employee's designated Roth account and any other accounts under the plan of an employer that has the effect of directly or indirectly transferring value from another account into the designated Roth account violates the separate accounting requirement under §402A.[1052] Commentators to the regulations requested guidance on how this rule applies to annuity contracts that provide guaranteed benefits affecting both Roth and non-Roth accounts under the contract. The preamble to the final regulations noted that:[1053]

> The IRS and Treasury Department believe that it may be difficult for a single contract to have combined guarantees that apply to both accounts without the potential for a prohibited transfer of value between the accounts, and have not issued guidance on how to account for these guarantees (including related charges). However, this issue will continue to be considered by the IRS and Treasury Department.

E. Roth Distributions

The distribution and rollover rules that apply to designated Roth accounts are among the more complicated aspects of a qualified Roth program. For a complete discussion, see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification.* The following is a high-level overview of the distribution rules with an eye to issues that are unique to administering a Roth contribution program.

[1046] §402A(b)(2)(A); Reg. §1.401(k)-1(f)(3). §402A(b)(2). Note that a "designated Roth account" refers to a separate account under a §401(a) plan and is different from a Roth IRA. Roth IRAs are discussed in 367 T.M., *IRAs.*
[1047] §402A(b)(2)(B); Reg. §1.401(k)-1(f)(3).
[1048] §402A(b)(2)(B); Reg. §1.401(k)-1(f)(3).
[1049] Reg. §1.401(k)-1(f)(3).
[1050] Reg. §1.401(k)-1(f)(3).
[1051] Reg. §1.401(k)-1(f)(3).
[1052] Reg. §1.402A-1, Q&A-13.
[1053] T.D. 9324, 72 Fed. Reg. 21,103, 21,107–08 (Apr. 30, 2007).

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1. *Roth Qualified Distributions*

A "qualified distribution" from a Roth account is not included in the recipient's gross income.[1054] A qualified distribution is a distribution that is made both (i) after the end of a five-year period (the "non-exclusion period," discussed below); and (ii) after age 59½, after death, or on account of disability.[1055]

Specifically, the non-exclusion period is a period of five taxable years that begins with the first tax year for which the participant made a contribution to any designated Roth account under the plan. However, if the participant made a direct rollover to the plan's Roth account from a Roth account under another retirement plan, and if it would result in a shorter non-exclusion period, the five-year non-exclusion period begins with the year that the participant first made a contribution to the Roth account under the other retirement plan from which the rollover was received.[1056]

A distribution from a designated Roth contributions account that is a corrective distribution of an elective deferral that exceeds the §402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution to correct an ADP testing failure is not a qualified distribution.[1057] In addition, excess contributions that are distributed to prevent an ADP failure do not begin the five-taxable-year period of participation.[1058] Further, contributions that are permissibly withdrawn by an employee under an eligible automatic contribution arrangement (pursuant to §414(w)) also do not start the five-taxable-year period of participation.[1059]

A hardship distribution is not precluded from being a qualified distribution.[1060]

2. *Roth Nonqualified Distributions*

A nonqualified distribution from a Roth contributions account is any distribution other than a qualified distribution. A nonqualified distribution is taxed under the rules of §402, which generally references §72, in the same manner as amounts attributable to after-tax employee contributions.

A nonqualified distribution from a designated Roth account is treated as a separate contract under §72.[1061] As a result, the portion of the distribution that is attributable to non-taxable investment in the contract and taxable earnings is determined without regard to any other accounts under the plan, including pre-tax elective deferral accounts and after-tax employee contribution accounts. This is comparable to the separate contract treatment for traditional after-tax employee contributions.[1062]

[1054] §402A(d)(1).

[1055] §402A(d)(2), cross-referencing §408A(d)(2)(A). *See* Reg. §1.402A-1, Q&A-2.

[1056] §408A(d)(2)(B); Reg. §1.402A-1, Q&A-4. A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a designated Roth contributions account under a §401(k) plan. §402A(d)(2), cross-referencing §408A(d)(2)(A) without regard to §408A(d)(2)(A)(iv).

[1057] §408A(d)(2)(C).

[1058] Reg. §1.402A-1, Q&A-4(a).

[1059] Reg. §1.402A-1, Q&A-4(a).

[1060] Reg. §1.402A-1, Q&A-11.

[1061] Reg. §1.402A-1, Q&A-3.

[1062] Notice 87-13.

3. *Hardship Distributions of Roth Contributions*

The general basis recovery rules of §72 apply to a hardship distribution from a designated Roth account in the same manner as they apply to any other distribution.

4. *Roth Rollovers out of a Plan*

A distribution eligible for rollover from a designated Roth account may be rolled over to a designated Roth account under another retirement plan, or to a Roth IRA. The rollover rules that apply to after-tax amounts generally apply to rollovers of amounts attributable to a Roth designated account.[1063]

A rollover of Roth contributions, which are eligible not to be included in income, to a designated Roth account under another retirement plan may be accomplished only through a direct rollover.[1064] However, a participant may conduct an indirect rollover of the entire distribution to a Roth IRA.[1065] The employee is also permitted to roll over the taxable portion of the distribution to a designated Roth account under another retirement plan.[1066]

Participants may direct to specific destinations pre- and after-tax amounts that are simultaneously disbursed from a single qualified plan. Therefore, participants may roll over pre-tax amounts to a traditional IRA or qualified plan (and thus continue to defer taxation on such amounts), while receiving cash distributions of after-tax amounts (or rolling such amounts over to a Roth IRA). Participants thus do not need to make pro rata allocations of the pre- and after-tax portions of each constituent distribution.[1067]

Practice Insight: This rule does not alter the requirement that each distribution from a plan include a proportional share of the pre-tax and after-tax amounts in the account. Any partial distribution from the plan must include some of the pre-tax amounts a participant has in his or her account; thus, a participant cannot take a partial distribution of only the after-tax amounts and leave the pre-tax amounts in the plan.

a. *Five-Year Non-Exclusion Period as Applied to Roth Rollovers to a Roth IRA*

The five-year non-exclusion period does not carry over from a plan to a Roth IRA.[1068] The period is determined separately for each, although an amount that is rolled from a plan to a Roth IRA that has satisfied the five-year period will enjoy the benefit of the Roth IRA's holding period.[1069]

[1063] Reg. §1.402A-1, Q&A-5. *See* Notice 2008-30, §II, *amplified and clarified by* Notice 2009-75.

[1064] Reg. §1.402A-1, Q&A-5(a), as amended by T.D. 9769, 81 Fed. Reg. 31,165 (May 18, 2016). T.D. 9769 removed the rule requiring separate distributions of amounts paid in a direct rollover and amounts paid directly to the employee for distributions made after 2015 and preserved the separate distribution rule for distributions made before 2016. Taxpayers may elect to not apply the separate distribution rule for distributions made on or after September 18, 2014, and before January 1, 2016. Reg. §1.402A-1, Q&A-5(a).

[1065] Reg. §1.402A-1, Q&A-5(a). For a discussion of the 60-day rollover period, see 367 T.M., *IRAs*.

[1066] Reg. §1.402A-1, Q&A-5(c).

[1067] *See* Notice 2014-54.

[1068] Reg. §1.408A-10, Q&A-4.

[1069] Reg. §1.408A-10, Q&A-4.

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Generally, separate five-year-taxable periods apply on a plan-by-plan basis.[1070] However, if there is a direct rollover (as opposed to an indirect rollover) of Roth contributions from one retirement plan to another, the employee may carry over any taxable years already accumulated under the distributing plan for purposes of determining the five-year non-exclusion period under the recipient plan.[1071]

b. Reporting and Recordkeeping of Roth Rollovers out of a Plan

From a plan administration perspective, the primary significance of the complicated Roth rollover rules is that special reporting rules apply. The plan administrator is generally responsible for keeping track of the five-taxable-year period of participation as well as a participant's basis in the account.[1072] In this regard, the plan administrator has an obligation to share this information with any plan receiving a direct rollover of the Roth amounts and providing such information to a participant in connection with a distribution upon request.[1073] The statement must be provided within a reasonable period following a distribution but in no event later than 30 days following the direct rollover or the employee's request.[1074]

A plan that accepts a rollover from a designated Roth account other than a direct rollover has an information reporting obligation to the IRS.[1075] The report must generally include identifying information about the employees as well as the amount rolled over and the year of the rollover.[1076] The report is intended to allow the IRS to confirm that the amount rolled over was a valid rollover.[1077] The reporting obligation, however, is only applicable to the extent provided for in IRS forms and instructions.[1078] A plan administrator is also entitled to rely on reasonable representations made by the distributing plan administrator in a rollover from a designated Roth account under another plan.[1079]

5. Multiple Contracts Under a Plan for Roth Contributions

Generally, for purposes of §72, there is only one separate contract for an employee with respect to the designated Roth contributions under a plan.[1080] Thus, if a plan maintains one separate account for designated Roth contributions made under the plan and another separate account for rollover contributions received from a designated Roth account under another plan (so that the rollover account is not required to be subject to the distribution restrictions otherwise applicable to the account consisting of designated Roth contributions made under the plan), both separate accounts are considered to be one contract for purposes of applying §72 to the distributions from either account.

Notwithstanding the above, if a separate account consisting of designated Roth contributions is established and maintained for an alternate payee pursuant to a qualified domestic relations order (QDRO) and another designated Roth account is maintained for the employee, each account is treated as a separate contract. The alternate payee's designated Roth account is also a separate contract with respect to any other account maintained for that alternate payee. Similarly, if separate accounts are established and maintained for different beneficiaries after the death of an employee, the separate account for each beneficiary is treated as a separate contract and also is a separate contract with respect to any other account maintained for that beneficiary under the plan that is not a designated Roth account. When the separate account is established for an alternate payee or for a beneficiary (after an employee's death), each separate account must receive a proportionate amount attributable to investment in the contract.[1081]

6. Excess Roth Contributions

The treatment of excess designated Roth contributions under §402(g) is similar to the treatment of excess deferrals attributable to non-Roth contributions.[1082] If excess Roth contributions (including earnings thereon) are distributed no later than the April 15th following the tax year, then the designated Roth contributions are not includible in gross income as a result of the distribution, because such contributions were includible in gross income when made.[1083] Earnings on such contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess designated contributions are not distributed by the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.[1084] The income allocable to Roth excess deferrals is calculated as determined as described in VII.E.2.e., below.

7. In-Plan Roth Rollovers

A plan that includes a Roth contribution program may allow participants to roll over their pre-tax account balances to Roth-designated accounts within the plan, even if the amount

[1070] Reg. §1.402A-1, Q&A-5(c).
[1071] Reg. §1.402A-1, Q&A-4(b).
[1072] Reg. §1.402A-2, Q&A-1.
[1073] §6047(f); Reg. §1.402A-2, Q&A-2(a).
[1074] Reg. §1.402A-2, Q&A-2(b).
[1075] Reg. §1.402A-2, Q&A-3.
[1076] Reg. §1.402A-2, Q&A-3.
[1077] Reg. §1.402A-2, Q&A-3.
[1078] Reg. §1.402A-2, Q&A-3.
[1079] Reg. §1.402A-2, Q&A-1.
[1080] Reg. §1.402A-1, Q&A-9.
[1081] Reg. §1.402A-1, Q&A-9.
[1082] See VII.E., below, for a discussion of the treatment of excess deferrals under §402(g).
[1083] §402A(d)(3).
[1084] §402A(d)(3). Not later than the first April 15 (or an earlier date specified in the plan) following the close of the individual's tax year, the individual may notify each plan under which elective deferrals were made of the amount of excess deferrals received by the plan. If designated Roth contributions were made, the notification must also identify the extent, if any, to which the excess deferrals are comprised of designated Roth contributions. A plan may provide that an individual is deemed to have notified the plan of excess deferrals to the extent the individual has excess deferrals for the tax year calculated by taking into account only elective deferrals under the plan and other plans of the same employer. The plan also may provide the extent to which the excess deferrals are comprised of designated Roth contributions. A plan may instead provide that the employer may notify the plan on behalf of the individual under these circumstances. Reg. §1.402(g)-1(e)(2)(i), §1.402(g)-1(e)(8)(iv).

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is not otherwise eligible for a distribution.[1085] This is known as an in-plan Roth rollover. A surviving spouse beneficiary or an alternate payee who is the employee's spouse or former spouse also can elect an in-plan Roth rollover.[1086]

Practice Insight: Use of an in-plan Roth rollover keeps the rolled funds in the employer sponsored plan, instead of being transferred to Roth IRA accounts of outside brokers and mutual fund companies. Maintaining the funds in the employer plan is often a less costly vehicle for the employee funds than outside vendors.

The rollover may take the form of a direct rollover (an "in-plan Roth direct rollover") or a distribution of funds to the employee who rolls over the funds into his or her designated Roth account in the plan within 60 days (an "in-plan Roth 60-day rollover").[1087] The distribution must be contributed in a "qualified rollover contribution" within the meaning of §408A(e).[1088]

Practice Insight: In-plan Roth rollovers generally result in taxable income to the participant, see V.E.7.b., below. As such, participants may want to increase their tax withholding for the period in which the in-plan Roth rollover is made.

Such in-plan Roth rollovers are treated as distributions that are subsequently contributed as a "qualified rollover contribution," within the meaning §408A(e), to the Roth account.[1089] However, even if amounts are not eligible for plan distribution, a plan is not treated as violating restrictions on distributions of elective deferrals from §401(k) plans.[1090]

A distribution that is rolled over in an in-plan Roth direct rollover is not treated as a distribution for certain purposes.[1091] Plan loan transfers accomplished without changing the repayment schedule are not treated as plan loan refinancings.[1092] Married plan participants are not required to obtain spousal consent in connection with the rollover election.[1093] The amount rolled over is taken into account in determining whether the participant's accrued benefit exceeds $7,000 ($5,000 for distributions made before 2024), and the rollover does not trigger a notice of the participant's right to defer receipt of the distribution.[1094] In addition, a distribution right a participant had before the in-plan Roth direct rollover is not eliminated by the rollover.[1095]

a. In-Plan Roth Rollover Restrictions

A plan that does not otherwise allow Roth contributions cannot establish Roth accounts solely to accept in-plan rollover contributions.[1096] The plan must allow Roth contributions before the rollover can be accomplished.

If the amount to be rolled over to a designated Roth account is not otherwise distributable under the plan, then the amount rolled over and applicable earnings remain subject to the distribution restrictions that were applicable to the amount before the in-plan Roth rollover.[1097]

> *Example:* A participant in a §401(k) plan makes an in-plan Roth rollover of amounts from his pre-tax elective deferral account prior to age 59½. The participant has not had a severance from employment. The amount rolled over and applicable earnings may not be distributed from the plan prior to the participant attaining age 59½ or the occurrence of another event described in §401(k)(2)(B).
>
> If the direct rollover is accomplished by a transfer of property to the designated Roth account (rather than cash), the amount of the rollover is the fair market value of the property on the date of the transfer.[1098]
>
> A plan may limit the type of contributions eligible for an in-plan Roth rollover and the frequency of in-plan Roth rollovers. However, any such limitations are subject to the nondiscrimination requirements normally applicable to plan benefits, rights, and features under §401(a)(4).[1099] For example, to simplify recordkeeping in a designated Roth account, a plan provides that only otherwise distributable amounts are eligible for in-plan Roth rollover.

b. Tax Treatment of In-Plan Roth Rollovers

The participant must include in gross income the fair market value of the rollover (subject to basis recovery) in the same manner as if the distribution were rolled over into a Roth IRA.[1100] The recognized amount is includible in income in the year of the rollover.[1101]

In-plan Roth rollovers generally are not subject to the 10% additional tax on early distributions under §72(t).[1102] However, unless there is an additional exception to the §72(t) 10% tax, the tax will apply if the taxable amount of an in-plan Roth rollover is distributed before the end of a the five-taxable-year period (known as a "recapture rule").[1103] The five-taxable-year period begins with the first day of the participant's tax year in which rollover was made, and the period ends on the last day of the participant's fifth tax year. The five-year recapture rule does not apply to a subsequent rollover to another designated Roth account or Roth IRA owned by the participant, but it does apply to subsequent distributions made from such other designated Roth account or Roth IRA within the five-year period.[1104]

In-plan Roth direct rollovers are not included in mandatory 20% withholding under §3405(c).[1105] Thus, if a person makes an

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[1085] *See* §402A(c)(4)(E). *See also* Notice 2013-74 (providing guidance on in-plan Roth rollovers (modifying Notice 2010-84)).

[1086] Notice 2010-84, Q&A-14.

[1087] Notice 2010-84, Q&A-1. However, unlike the in-plan Roth rollover for currently distributable amounts, the expanded nondistributable amounts election under Notice 2013-74 applies only to in-plan Roth direct rollovers, and not to in-plan Roth 60-day rollovers. *See* Notice 2013-74, Q&A-1.

[1088] §402A(c)(4)(B).

[1089] §402A(c)(4)(E)(ii).

[1090] §402A(c)(4)(E)(iii).

[1091] Notice 2010-84, Q&A-3.

[1092] §72(t).

[1093] §401(a)(11).

[1094] §411(a)(11), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §304 (increasing distribution threshold).

[1095] §411(d)(6)(B)(ii).

[1096] Notice 2010-84, Q&A-19.

[1097] Notice 2013-74, Q&A-3.

[1098] Technical Explanation of 2010 SBJA at 43.

[1099] Notice 2013-74, Q&A-6. *See* 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*, for a discussion of the nondiscrimination requirements applicable to plan benefit, rights and features under §401(a)(4).

[1100] §402A(c)(4)(A)(i); Notice 2010-84, Q&As-7 and -13.

[1101] Notice 2010-84, Q&A-9.

[1102] §402A(c)(4)(A)(ii).

[1103] Notice 2010-84, Q&A-12.

[1104] §402A(c)(4)(D), §408A(d)(3)(F); Notice 2010-84, Q&A-12.

[1105] Notice 2010-84, Q&A-8. *See* Notice 2013-74, Q&A-4.

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in-plan Roth direct rollover and any amount is taxable, the person may have to increase the federal income tax withholding or make estimated tax payments to avoid an underpayment of the tax penalty.[1106]

If an employee rolls over into a designated Roth account all of his funds from other accounts in the same plan, and the amount is later determined to be an excess amount (that is, an excess deferral described in §402(g)(2)(A), an excess contribution described in §401(k)(8)(B) or an excess aggregate contribution described in §401(m)(6)(B)), and the excess amount (plus applicable earnings) is to be distributed from the plan, then the excess amount (plus applicable earnings) must be distributed from the designated Roth account, even if the amount was an otherwise nondistributable amount at the time of the in-plan Roth rollover.[1107]

[1106] Notice 2010-84, Q&A-8; IRS Retirement News for Employers (Jan. 2011). *See* Notice 2013-74, Q&A-4.

[1107] Notice 2013-74, Q&A-11.

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VI. Eligible Automatic Contribution Arrangements

There are at least three types of automatic contribution arrangements for tax purposes. The first is a general automatic contribution arrangement that does not avail itself of any special tax rules other than the "effective opportunity" requirement described in II.B.2., above. The second is a qualified automatic contribution arrangement, which is a type of safe harbor plan described in §401(k)(13) and is discussed in IV.C., above. The third is an eligible automatic contribution arrangement.

An eligible automatic contribution arrangement (EACA) is a special type of automatic enrollment provision under §414(w) that may be designed to allow one or both of the following features: (1) eligible employees to withdraw certain contributions to a CODA made on their behalf under a default election without paying the early withdrawal tax if the withdrawal election is made shortly after they have been automatically enrolled; and/or (2) an extended period of six months after the end of the plan year, rather than 2½ months, to correct excess contributions under the ADP test and excess aggregate contributions under the ACP test and avoid the related excise tax on excess contributions. The extended correction period is only available if the EACA covers all employees of the employer, while the permissible withdrawal rule has no such requirement. In addition, the EACA must satisfy a uniformity requirement, notice requirements, and a plan year requirement in order to offer either of these features.[1108] Qualification as an EACA alone does not provide any relief from the ADP or ACP tests or the top-heavy rules of §416, as an EACA is not a safe harbor plan. However, an EACA may be part of QACA, another safe harbor design under §401(k)(12) or §401(k)(13) or a basic CODA. It may also be part of a SIMPLE IRA.[1109] The IRS has provided sample plan amendments that may be used to add an automatic contribution arrangement to a §401(k) plan or to add an EACA to a §401(k) plan.[1110]

A. *Permissible Withdrawals Under an EACA*

The eligible automatic contribution arrangement (EACA) provisions were enacted as a means of facilitating automatic enrollment arrangements, and the advantages associated with EACAs were intended to address a perceived shortfall with automatic contribution arrangements. Automatic enrollment programs often involve employees that choose to discontinue elective contributions shortly after the default contributions have commenced. These employees may complain that they did not appreciate that they would be automatically enrolled absent an affirmative election to the contrary and that they should be able to "unwind" their automatic enrollment. As such, an EACA may be designed to allow automatically enrolled participants to unwind their enrollment by electing to withdraw contributions shortly after they have been automatically enrolled, notwithstanding the general prohibition against in-service withdrawals.[1111]

Further, a plan may become burdened by the administrative expense associated with numerous accounts with very small account balances if employees frequently opt out shortly after automatic enrollment. The permissible withdrawal feature addresses these concerns by offering automatically enrolled participants the opportunity to elect to withdraw the automatic contributions that were made on their behalf plus earnings provided that the election is made within 90 days after the first default contribution is made on their behalf.

Except to the extent required under §414A, the EACA is not required to cover all employees of the employer in order to take advantage of the permissible withdrawal feature, but inclusion of the extended correction period for ADP and ACP testing in the EACA is conditioned upon the EACA covering all employees.[1112] As such, an EACA may be designed to provide for permissible withdrawals without including, or being eligible for, the extended correction period provision. As discussed below, however, it may be difficult to administer to the permissive withdrawals and satisfy the ADP and ACP tests without the benefit of the extended correction period, given that the timeframe for requesting a permissive withdrawal may extend beyond the regular deadline for performing and correcting the ADP and ACP tests for the plan year.

1. *Timing of Elections and Withdrawals*

A covered employee's election to withdraw default elective contributions under an EACA must be made no later than 90 days after the date of the first default elective contribution under the EACA.[1113] A plan may impose an earlier deadline, provided that the election period is at least 30 days.[1114] The date of the first default elective contribution is not the date that the contribution is made to the plan's trust or other funding vehicle, but rather is the date that such amount would have been paid to the employee but for the negative election arrangement.[1115]

The election must be effective by no later than the earlier of the pay date for the second payroll period that begins after the date the election is made or the first pay date that occurs at least 30 days after the election is made.[1116] In this regard, the amount that must be distributed is the amount deferred prior to the effective date of the permissible (or permissive) withdrawal

[1108] As initially enacted in the 2006 PPA, default contributions under the arrangement had to be invested in a qualified default investment alternative under ERISA §404(c)(5). The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), however, eliminated this investment requirement retroactively. Pub. L. No. 110-458, §109(b)(4).

[1109] The IRS has requested comments on whether it should issue guidance regarding SIMPLE IRA plans that include EACAs and, if so, what guidance is needed for an EACA that is part of a SIMPLE IRA; Notice 2009-66. If such guidance is ever issued, it may be instructive on applying the EACA provisions of §414(w) to CODAs.

[1110] Notice 2009-65.

[1111] §414(w)(2).

[1112] Reg. §1.414(w)-1(b)(1), §54.4979-1(c)(1). *See* Prop. Reg. §1.414(w)-1(b)(1), REG-100669-24, 90 Fed. Reg. 3092 (Jan. 14, 2025), proposed to apply to plan years beginning after the date that is six months after the publication of a final rule.

[1113] §414(w)(2)(B). See Rev. Proc. 2018-58 (period may be postponed under §7508A, as amended by Pub. L. No. 117-58, §80504, due to federally declared disaster, a significant fire, or terroristic or military action, and is postponed under §7508(a)(1)(K) for qualifying individuals serving in the Armed Forces in a combat zone or in a contingency operation). For further discussion of plan-related postponements due to disaster situations (or service in the Armed Forces), see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*, and 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation.*

[1114] Reg. §1.414(w)-1(c)(2)(i).

[1115] Reg. §1.414(w)-1(c)(2)(ii).

[1116] Reg. §1.414(w)-1(c)(2)(iii).

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election.[1117] This may require segregating amounts because an employee that elects a permissible withdrawal may nonetheless continue making elective deferrals.[1118] However, a plan may allocate gains and losses under rules similar to the rules that apply for the distribution of excess contributions.[1119]

Presumably, most employees that elect permissible withdrawals will discontinue elective deferrals as well, but there is no rule requiring the discontinuance of elective contributions simply because an employee elected a permissible withdrawal. In fact, a plan may not condition a permissible withdrawal on a discontinuance of elective contributions since such a rule would violate the contingent benefit of §401(k)(4)(A), which is discussed in II.F.1., above.[1120] It is, however, permissible to provide that the default in the event of a permissible withdrawal is a discontinuance of elective contributions.[1121]

It is implicit in the EACA timing rules that a participant may make only one permissible withdrawal election. However, a special rule provides that a rehired employee may make a second permissible withdrawal election provided that the employee did not have default elective contributions made under the EACA for an entire plan year.[1122] This is a corollary to the rule that allows a plan to disregard a rehired employee's prior service for uniformity rule purposes if the employee has an entire year outside the automatic contribution arrangement.

The distribution amount may be reduced by generally applicable fees but a plan may not charge a higher fee for a permissible withdrawal than would be charged for other distributions of cash.[1123]

There is no special rule regarding when distributions must be made in connection with a permissible withdrawal. The rules that apply are the general rules for making distributions from the plan, which are often described in the plan document.[1124] In the ordinary course, however, a distribution typically will be made as soon as administratively practicable following the effective date of the election since the participants who make such an election will presumably be anxious to receive the distribution.

2. *Tax Consequences of Permissible Withdrawals*

The amount of a permissible withdrawal is generally included in the gross income of the employee in the year of the withdrawal.[1125] Thus, even though the contribution may have been made in a different tax year, the distribution is taxed in the year of distribution. The basis recovery rules are modified to provide that the portion of the distribution that is allocable to basis is determined without regard to other after-tax contributions.[1126] As a result, for example, a permissible withdrawal attributable to Roth contributions will be received tax-free except to the extent of gain attributable to such contributions.

A permissible withdrawal is not subject to the additional 10% tax under §72(t) and is reported on the Form 1099-R, not the Form W-2.[1127] In addition, a permissible withdrawal is not considered an eligible rollover distribution[1128] and, correspondingly, is not subject to mandatory 20% income tax withholding.[1129]

The amount of a permissible withdrawal under §414(w) is not taken into account in determining whether the plan has met the applicable §402(g) limitations.[1130] In addition, an amount that is permissively withdrawn is not taken into account in performing the ADP test.[1131] Consent is not required to a permissible withdrawal even in a plan that generally requires spousal consent to distributions.[1132]

Employer matching contributions attributable to an elective contribution that is later withdrawn must be forfeited[1133] along with allocable gains and losses.[1134] A matching contribution that is forfeitable as a result of a permissible withdrawal does not fail to qualify as a qualified matching contribution.[1135] A plan is also allowed to forgo the matching contribution on an amount that is permissively withdrawn if the match is made after the withdrawal.[1136]

B. *Extended Correction Period for Excess Contributions Under the ADP and ACP Tests*

The extended correction period for correcting excess contributions under the ADP and ACP tests is a corollary of the permissible withdrawal rule. As discussed below, permissible withdrawals under an EACA are not taken into account in applying the ADP test. However, a plan will not know whether a participant has made a permissible withdrawal for as long as 90 days after the first default contribution is made. Thus, in the absence of an extended period to perform the ADP test, a plan would otherwise run into a timing problem due to the fact that excess contributions must ordinarily be corrected within 2½ months of the end of the plan year. To address this issue, an EACA is generally entitled to a six-month period, rather than a 2½-month correction period.

An important limitation on an EACA is that the plan will not be eligible for the extended correction period unless all the eligible non-HCEs and eligible HCEs are covered employees under the EACA.[1137] However, the arrangement would still qualify as an EACA and, therefore, may offer the permissible withdrawal feature, even if it covers fewer than all employees eligible to participate.[1138] As such, it is possible for an EACA

[1117] Reg. §1.414(w)-1(c)(3)(i).
[1118] Reg. §1.414(w)-1(c)(3)(i).
[1119] Reg. §1.414(w)-1(c)(3)(i).
[1120] Reg. §1.414(w)-1(e)(1)(i).
[1121] 72 Fed. Reg. at 63,147–48 (preamble to proposed automatic contribution arrangement regulations).
[1122] Reg. §1.414(w)-1(c)(2)(iv)(A).
[1123] Reg. §1.414(w)-1(c)(3)(ii).
[1124] Reg. §1.414(w)-1(c)(3)(iii).
[1125] Reg. §1.414(w)-1(d)(1)(i).
[1126] Reg. §1.414(w)-1(d)(1)(i).
[1127] Reg. §1.414(w)-1(d)(1)(ii), §1.414(w)-1(d)(1)(iii).
[1128] Reg. §1.402(c)-2(c)(3)(viii), pre-2025 Reg. §1.402(c)-2, Q&A-4(h).
[1129] §3405(c)(1).
[1130] §414(w)(6); Reg. §1.414(w)-1(d)(1)(iv). WRERA retroactively amended §414(w)(6) to clarify that a permissible withdrawal is not taken into account under §402(g). Pub. L. No. 110-458, §109(b)(6).
[1131] §414(w)(6); Reg. §1.401(k)-2(a)(5)(vi).
[1132] Reg. §1.414(w)-1(d)(3).
[1133] §414(w)(1) (flush language).
[1134] Reg. §1.414(w)-1(d)(2).
[1135] Reg. §1.401(k)-2(b)(4)(iii).
[1136] Reg. §1.414(w)-1(d)(2).
[1137] Reg. §1.401(k)-2(b)(5)(iii), effective for plan years beginning on or after January 1, 2010; Reg. §54.4979-1(c)(1).
[1138] Reg. §1.414(w)-1(b)(1), §54.4979-1(c)(1). In this regard, the applicable regulations condition the extended coverage period upon the EACA covering all employees of the employer while the permissible withdrawal rule has no

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to be designed not to offer permissible withdrawals but still enjoy the six-month correction period. Notwithstanding the connection between permissible withdrawals and the extended correction period, a plan sponsor may make such a choice due to the administrative complexity associated with having to offer permissible withdrawals, while still wanting to take advantage of the option of additional time to satisfy the ADP and ACP tests. Regardless of whether the EACA offers permissible withdrawals, the extended correction period may still be beneficial to a plan that is already deemed to have satisfied the ADP test, such as by being a §401(k)(12) safe harbor plan or a §401(k)(13), in circumstances where the plan is still subject to the ACP test (i.e., the plan does not limit contributions to the extent necessary to be deemed to have satisfied the ACP test).

C. Uniformity, Notice, and Plan Year Requirements

An EACA must satisfy the uniformity, notice, and plan year requirements, regardless of whether it includes both the permissible withdrawal and extended correction periods, or only one of these features.

1. Uniformity Requirement

In general, an EACA must provide that the default elective contribution is a uniform percentage of compensation, pursuant to §414(w) and the regulations thereunder.[1139] The uniformity requirement that applies to EACAs is essentially the same uniformity requirement that applies to QACAs.[1140] The same four exceptions to the uniformity requirement that apply to a QACA also apply to an EACA, which are as follows:[1141]

(1) The percentage may vary based on the number of years (or portions of years) since the beginning of the "initial period" for an eligible employee;

(2) The rate of elective contributions in effect for an employee under the CODA is not reduced below the rate immediately in effect prior to the effective date of the EACA;

(3) The rate of elective contributions is limited in light of the limits of §401(a)(17), §402(g), and §415; or

(4) The default election is not applied during a period in which elective contributions must be suspended under §414(u)(12)(B)(ii), which provides for distribution upon a deemed severance from employment while performing military service.

Practice Insight: The uniformity rules for EACAs are somewhat surprising. Unlike a QACA, an EACA is not a safe harbor plan and the advantages of EACA treatment are fairly modest. Nonetheless, the applicable EACA requirements employ many of the rules that apply to a QACA.

In applying the uniformity requirement to an EACA, all automatic contribution arrangements that are intended to be EACAs within a plan are aggregated.[1142] Thus, for example, if a single plan had an automatic contribution arrangement that automatically enrolled employees in Division A at 3% and employees in Division B at 5%, the plan would not satisfy the uniformity requirement. The uniformity requirement applies to the plan within the meaning of §414(l), but the uniformity requirement does not apply across portions of the plan that are subject to mandatory disaggregation under the rules of §410(b), such that collectively bargained employees may be covered by an EACA with one contribution structure while non-collectively bargained employees are covered by an EACA with a different contribution structure.[1143] Similarly, an employer may maintain two or more §401(k) plans, each with a different automatic enrollment structure and still qualify each as an EACA.

It is unclear whether a default contribution feature that applies to some but not all eligible employees is subject to nondiscrimination testing under §401(a)(4) as a benefit, right, or feature. The regulations provide that the right to make each rate of elective contributions is an "other right or feature" subject to testing but nothing in the regulations speaks to whether default contributions are subject to testing.[1144] The regulations also indicate that a feature is not considered an "other right or feature" if it cannot be reasonably expected to be of meaningful value to an employee,[1145] and it is arguable whether a negative election feature is of meaningful value.

The uniformity requirement relates only to the percentage of compensation for default elective contributions among employees who are, in fact, covered by the EACA, but it does not require that automatic enrollment under the EACA cover all eligible employees. As such, it is permissible to apply an automatic contribution arrangement that is intended to be an EACA only to new hires after the date the arrangement is effective or only to a particular division or subgroup of the employer.[1146] As discussed above, however, an EACA must cover all eligible employees in order for it to contain the six-month, extended correction period for the ADP and ACP tests.

Practice Insight: Perhaps the most common automatic contribution arrangement is one that covers new hires after the date the arrangement is implemented.

For automatic contributions arrangements that include an automatic escalation feature, the first exception discussed above permits different default contribution rates to apply to different employees without violating the uniformity rule if the differences are based on the employee's "initial period." In the EACA context, however, the reference to the term initial period is a bit confusing because it is a term used only for QACAs. Under the uniformity regulations, the initial period begins when the employee first has contributions made pursuant to a default election under an arrangement that is intended to be a QACA for a plan year and ends on the last day of the following plan year.[1147] Presumably, the initial period in the EACA context is based on the date the employee first has contributions made pursuant to a default election under the EACA, rather than a QACA or a general automatic contribution arrangement.

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such requirement. *See* Prop. Reg. §1.414(w)-1(b)(1), REG-100669-24, 90 Fed. Reg. 3092 (Jan. 14, 2025) (clarifying an arrangement would still qualify as an EACA for covering less than all eligible employees except to the extent required under §414A), proposed to apply to plan years beginning after the date that is six months after the publication of a final rule.

[1139] §414(w)(3)(B); Reg. §1.414(w)-1(b)(2)(i).

[1140] Reg. §1.414(w)-1(b)(2)(ii).

[1141] Reg. §1.401(k)-3(j)(2)(iii).

[1142] Reg. §1.414(w)-1(b)(2)(iii).

[1143] Reg. §1.414(w)-1(b)(2)(iii).

[1144] Reg. §1.401(a)(4)-4(e)(3).

[1145] Reg. §1.401(a)(4)-4(e)(3)(ii)(C).

[1146] T.D. 9447, 74 Fed. Reg. at 8204. *See* Reg. §1.414(w)-1(b)(2)(iii).

[1147] Reg. §1.401(k)-3(j)(2)(ii)(A).

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The initial period is also relevant because this uniformity exception permits the default contribution rates to vary based on the number of years, as well as portions of years, since the beginning of the "initial period" for an eligible employee. The phrase "portion of years" has been interpreted to mean that the plan may specify a uniform date upon which the automatic escalation will become effective, such as the first day of the plan year or on another specified date.[1148]

Practice Insight: There is some question whether automatic increases may be determined by the reference to the date of hire or even initial eligibility to participate in the plan. The reference to an employee's initial period suggests that the only date that an automatic escalation may be implemented is the anniversary of the date of the first contribution or a fixed date, such as the first day of the plan year. It can be argued, however, that the uniformity requirement would be satisfied if automatic escalation occurs on the date of hire or the date of initial eligibility because the date of the escalation would still bear a uniform relationship to the date of the first contribution assuming that the plan has a uniform waiting period.

In addition, the regulations provide that for purposes of determining the date of the first default elective contribution, a plan is permitted to treat an employee who for an entire plan year did not have default elective contributions made under the EACA as if the employee had not had such contributions for any prior plan year as well. In other words, an employee who is rehired within one year of termination, during which no contributions were made on his or her behalf, would be required to have his or her deferral rate increased as if he or she had continued to be covered by the arrangement during the period of termination.[1149] Similarly, any period in which contributions are suspended by reason of a hardship distribution would need to be taken into account in applying the scheduled increases.[1150]

2. *Notice Requirements*

The administrator of a plan containing an EACA must provide a notice of the employee's rights and obligations under the arrangement which is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations, and the notice must be written in a manner calculated to be understood by the average employee to whom the arrangement applies.[1151]Under proposed regulations, the EACA notice could be consolidated with other required notices under §401(k)(12)(D) or §401(k)(13)(E), as well as ERISA §404(c)(5)(B), §514(e)(3), or §801(d)(3)(A). Such consolidated notices would be required to satisfy several conditions, including containing all required content, clearly identifying each issue addressed, adhering to the timing and frequency requirements applicable to each included notice, being understandable to the average plan participant, and prominently highlighting critical information specific to each notice without obscuring it. In the case of unenrolled individuals, if the conditions for eliminating unnecessary disclosures to an unenrolled participant under §414(bb) are satisfied, the administrator would be relieved from the mandatory requirement to provide the EACA notice to that participant.[1152]

The notice must be provided to each "covered employee."[1153] The regulations define the term "covered employee" to include an employee who is covered under the automatic contribution arrangement, determined under the terms of the plan.[1154] The plan must provide whether an employee who makes an affirmative election remains a covered employee. If a plan provides that an employee who makes an affirmative election (either to have no contributions made or to have contributions made in a different percentage of compensation) remains a covered employee, then the employee must continue to receive the notice, and the plan may be eligible for the excise tax relief with respect to excess amounts distributed within six months after the end of the plan year under §4979(f)(1).[1155] Such an employee will also have the default election reapply if the plan provides that the employee's prior affirmative election no longer remains in effect and the employee does not make a new affirmative election.[1156]

As mentioned above, the regulations provide that the EACA must apply to all employees who are eligible to make a cash or deferred election under the plan in order for the arrangement to obtain the benefit of the extended correction period for ADP and ACP testing. Thus, in order for an EACA to obtain the extended correction period, the notice must be provided to all employees who are eligible to make a cash or deferred election, regardless of whether the employees have made an affirmative election. In contrast, an EACA that is merely availing itself of the permissible withdrawal feature is only required to provide the notice to all employees who are covered by the automatic contribution arrangement, but not employees who must make an affirmative election in order to participate.[1157]

Notwithstanding that an EACA does not have to qualify as a QACA, the same notice requirements that apply to QACAs generally apply to EACAs.[1158] Thus, the notice will not be considered sufficiently accurate and comprehensive unless the notice describes the level of default elective contributions which will be made on the employee's behalf if the employee does not make an affirmative election, the right to elect not to have default elective contributions made to the plan on his or her behalf or to have a different percentage of compensation or different amount of contribution made to the plan on his or her behalf, how contributions made under the arrangement will be invested in the absence of any investment election by the employee, and the right to make a permissible withdrawal, if applicable, and the procedures to elect such a withdrawal.[1159] In addition, the notice must include the provisions found in Reg. §1.401(k)-3(d)(2)(ii) to the extent those provisions apply to the arrangement.

The timing rules for providing EACA notices appear to follow the same rules that apply to a QACA, although the regu-

[1148] Rev. Rul. 2009-30.
[1149] Reg. §1.401(k)-3(j)(2)(iv).
[1150] Reg. §1.401(k)-3(j)(2)(iv).
[1151] §414(w)(4)(A); Reg. §1.414(w)-1(b)(3)(i).
[1152] Prop. Reg. §1.414(w)–1(b)(4)(i). For discussion of consolidated defined contribution plan notices and the conditions for eliminating unnecessary disclosures to unenrolled participants, see 361 T.M., *Reporting and Disclosure Under ERISA*.
[1153] Reg. §1.414(w)-1(b)(3)(i).
[1154] Reg. §1.414(w)-1(e)(3).
[1155] Reg. §1.414(w)-1(e)(3).
[1156] Reg. §1.414(w)-1(e)(3).
[1157] Reg. §1.414(w)-1(e)(3).
[1158] *Compare* Reg. §1.401(k)-3(k)(4) *with* Reg. §1.414(w)-1(b)(3).
[1159] Reg. §1.414(w)-1(b)(3)(ii).

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lations note that an employee who first becomes covered under the automatic contribution arrangement as a result of a change in employment rather than being newly hired may be treated in the same manner as a new hire.[1160] Thus, the annual notice must be given to covered employees at least 30 days (and no more than 90 days) before the beginning of each plan year, and to newly covered employees no more than 90 days before the employee becomes eligible to make a cash or deferred election and no later than the date that affords such employee a reasonable period of time after receipt of the notice to make the an election to have no contributions made or to have contributions made in a different percentage of compensation than under the EACA.[1161]

3. *Plan Year Requirement*

The EACA must be in place for the entire plan year in order for a plan to avail itself of the extended correction period for excess contributions, pursuant to the regulations under the §4979 excise tax penalties.[1162] As a result, an EACA may not be added to a plan during a plan year and obtain the benefit of the extended correction period. However, in subsequent plan years, the extended correction period would be available, provided that the EACA otherwise satisfies the applicable rules, including the requirement that the EACA cover all eligible employees.

Section 414(w) and the regulations thereunder do not have an explicit plan year requirement, and the question of whether an EACA could be implemented during the middle of a plan year with only a permissible withdrawal feature was a hotly contested issue during the regulatory process.[1163] The preamble to the final automatic contribution arrangement regulations indicates that a mid-year EACA could not satisfy the notice requirements, which generally require notice prior to the start of the plan year.[1164] Thus, it is apparent that a mid-year EACA with only a withdrawal feature may not be implemented for current employees.

The regulations are, however, less clear about whether an EACA that only covers new hires after the effective date may be implemented during a plan year. The basic problem is that the statute requires that a notice be provided before the start of the plan year. However, the notice timing rules are not a problem if the EACA only applies to new hires. The regulations provide that the notice only needs to be provided to participants covered by the EACA, which could include only new hires.[1165] In addition, the notice must be provided within a reasonable period before an employee becomes a covered employee if the employee is first eligible to make a cash or deferred election during the year.[1166] Taken together, it would appear that the notice requirement is satisfied if notices are given to new hires during the year, suggesting that a mid-year EACA for new hires with only a withdrawal feature is permissible. However, the regulations provide that an EACA is an automatic contribution arrangement "that is intended to be an eligible automatic contribution arrangement for the plan year,"[1167] which suggests an implied plan year requirement.

[1160] *Compare* Reg. §1.401(k)-3(k)(4)(iii) *with* Reg. §1.414(w)-1(b)(3)(iii).
[1161] Reg. §1.414(w)-1(b)(3)(iii).
[1162] Reg. §54.4979-1(c).
[1163] T.D. 9447, 74 Fed. Reg. at 8205.
[1164] T.D. 9447, 74 Fed. Reg. at 8205.
[1165] Reg. §1.414(w)-1(b)(3)(iii).
[1166] Reg. §1.414(w)-1(b)(3)(iii).
[1167] Reg. §1.414(w)-1(b)(1).

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VII. Section 402(g) Limit on Elective Deferrals

Section 402(g) imposes a limit on the total elective deferrals that an individual can make in any tax year.[1168]

Practice Insight: For most individuals, the tax year is the calendar year.

Practice Insight: The §402(g) limit was enacted as part of the Tax Reform Act of 1986. The purpose of the limit was to reduce the benefits of highly compensated individuals and limit federal revenue loss resulting from qualified CODAs.

The §402(g) limit is both an individual limit, in that it has tax ramifications for individuals, and a qualification requirement for plans.

A. Amount and Calculation of the §402(g) Limit

The §402(g) limit is $15,000,[1169] adjusted to reflect changes in the cost of living.[1170] The §402(g) limit applies to the tax year of the individual as opposed to the plan year or the calendar year.

Practice Insight: It is possible that a participant in a non-calendar year plan can defer as much as twice the §402(g) limit in a given plan year, once in each tax year which overlap with the plan year. Although this would preclude elective contributions under the plan in the remaining portions of those tax years.

Therefore, in applying the §402(g) limit, it is important to know the tax year for which each elective deferral must be taken into account. The elective deferrals are taken into account for the tax year in which they would have been included in the individual's gross income, i.e., the tax year in which the amounts would have been paid but for the deferral election.[1171]

> *Example:* An elective deferral taken out of a December 2019 paycheck will be counted as an elective deferral for 2019, even if it is not paid by the employer to the trust until January 2020.
>
> The §402(g) limit applies to all §401(k) and similar arrangements (including SIMPLE plans, SIMPLE IRAs, SARSEPs, and 403(b) plans) that the individual defers to during the tax year.[1172] The limit applies even if such arrangements are maintained by unrelated employers.[1173] An individual is responsible for monitoring the limit if the individual defers to plans of unrelated employers. However, see "Section 402(g) Limit as a Qualification Requirement" for a discussion of an employer's responsibility with respect to the §402(g) limit.
>
> The §402(g) limit is not prorated.[1174]
>
> *Example:* An individual with a calendar year tax year becomes eligible for an employer's §401(k) plan on July 1. The individual has not made any other elective deferrals to other retirement plans that year. Subject to plan provisions which may limit deferrals to a selected percentage of compensation, the individual may defer the full §402(g) limit for that calendar year, notwithstanding that the individual will only participate in the plan for five months.
>
> Section 402(g) is to be applied "without regard to community property laws."[1175] This is apparently intended to prevent the argument that, in community property states, a married individual may elect to defer twice the §402(g) limit, once for each spouse.

Practice Insight: Because of the §402(g) limit on elective deferrals, some plans that provide for matching contributions with respect to elective deferrals ensure that participants may continue contributions beyond the §402(g) limit on an after-tax basis in order to continue benefiting from the matching contributions. After-tax contributions must be available to a nondiscriminatory group of employees, however, and not merely to employees who exceed the limit.[1176] In addition, because after-tax and matching contributions are aggregated for purposes of ACP testing, the extra strain on the nondiscrimination test of that section may result in some or all of the matching contributions received on account of the after-tax contributions being returned to the highly compensated employees or forfeited.

B. Elective Deferrals to Which §402(g) Applies

Elective deferrals that are subject to the §402(g) limit include:

> (1) any employer contribution under a qualified CODA to the extent excludible from gross income (see I.D.3., above, for a discussion of the use of the term "employer contribution");
>
> (2) any designated Roth contributions described in §402A;
>
> (3) any employer contribution excludible from gross income under §402(h)(1)(B), relating to certain simplified employee pensions (SEPs) that operate like qualified CODAs;
>
> (4) any employer contribution toward an annuity contract, mutual fund custodial account, or church-sponsored retirement income account under §403(b) "under a salary reduction agreement";
>
> (5) any elective employer contribution under §408(p)(2)(A)(i) relating to SIMPLE plans; and
>
> (6) any deductible contribution under certain pre-June 25, 1959, trusts.[1177]

[1168] §402(g).

[1169] §402(g)(1)(B).

[1170] §402(g)(4). The $15,000 limit is adjusted to reflect changes in the cost of living, determined at the same time and in the same manner as under §415(d), except that the base period is the calendar quarter beginning July 1, 2005. Changes in the cost of living are based on changes in the Consumer Price Index. *See* 1986 Conf. Rep. II-387; *See* Reg. §1.415(d)-1. For the indexed amount, see the cost of living adjustments applicable to §401(k) plans in the Worksheets.

[1171] §402(g)(3)(A), §402(g)(3)(B). *See* Reg. §1.402(g)-1(b)(1), §1.402(g)-1(b)(2), §1.401(k)-1(a),§1.402(a)-1(d).

[1172] §402(g)(3).

[1173] Reg. §1.402(g)-1(e)(11) *Ex.* 1.

[1174] Reg. §1.402(g)-1(f).

[1175] §402(g)(5); Reg. §1.402(g)-1(f).

[1176] Reg. §1.401(m)-1(a)(2).

[1177] §402(g)(3); Reg. §1.402(g)-1(b). Designated Roth contributions are discussed in V., above.

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Practice Insight: Pension-Linked Emergency Savings Account ("PLESA") contributions are treated as designated Roth contributions for purposes of the limits under §402(g).[1178] Informal question and answer guidance supports this treatment.[1179]

Certain contributions which, though elective in form, are not elective in substance, are excluded from the above definition of elective deferrals. Accordingly, contributions are not elective deferrals if made pursuant to an employee's one-time, irrevocable election:

> (1) in the case of an annuity contract under §403(b), at the time of initial eligibility to participate in the employer's plans or a contribution made as a condition of employment;[1180]
>
> (2) in the case of a qualified CODA, upon commencement of employment or initial eligibility for any plan of the employer to have contributions of any specific amount made under the CODA or any other plan, for the duration of employment; or
>
> (3) in the case of a pre-June 25, 1959, trust, at the time of initial eligibility to have the employer contribute on the employee's behalf to the trust.[1181]

In addition to the one-time irrevocable elections specified in the statute and regulations, other types of contributions may be elective in form but not in substance and presumably are not included in the definition of an "elective deferral." For example, salary reduction contributions under a qualified retirement plan may be required as a condition of employment, at least for employees who have completed a specified period of service or attained a specified age, or both. The 1986 TRA Conference Report, in discussing the applicability of the §402(g) limit to salary reduction contributions under §403(b), states that contributions required as a condition of employment, or made pursuant to a one-time irrevocable election to participate in a program requiring a fixed contribution rate, are not to be treated as elective contributions subject to the §402(g) limit.[1182] The same should be true of similar contributions made under a qualified retirement plan instead of under §403(b).

Another example of a contribution that is elected but is not an "elective deferral" is a contribution elected by the employee in lieu of another, non-taxable benefit. For example, the IRS, in Rev. Rul. 2009-31 and Rev. Rul. 2009-32, concluded that, where employees had the option of taking certain vacation time in a year or having the company contribute the value of that time to a qualified plan, and the vacation time would otherwise have been forfeited, there was no choice between cash (or any other taxable benefit) and the employer contribution to the plan.[1183] Accordingly, contributions to the plan were not made under a cash or deferred arrangement. Presumably, the contributions were not elective deferrals under §402(g) for the same reason.

Elective deferrals that are catch-up contributions are not subject to the §402(g) limit ($15,000, as adjusted). For tax years beginning after December 31, 2023, the SECURE 2.0 Act of 2022 removes the paragraph in §402(g) that provides for this exclusion.[1184] Nonetheless, for tax years beginning after December 31, 2023, an applicable employer plan may continue to permit an eligible participant to make elective deferrals under the plan that exceed the §402(g) limit if those contributions satisfy the requirements under §414(v) for catch-up contributions.[1185] The rules governing catch-up contributions are discussed in VIII., below.

Generally, matching contributions made on behalf of a self-employed individual under a qualified CODA are not treated as elective deferrals, and therefore are not subject to the §402(g) limit.[1186]

C. Section 402(g) Limit as a Qualification Requirement

In addition to a limit that applies to individuals, a plan must comply with the §402(g) limit to remain qualified.[1187] Thus, a §401(k) plan must provide that the amount of elective deferrals under the plan and all other plans maintained by the same §414 control group, will be limited as required by §402(g). If the limit is exceeded, the plan must correct excess deferrals via distribution as described below in order to maintain qualification.

D. Reporting of Deferrals by Employer

Each employer must report to each employee, on Form W-2 for a tax year, the total amount of elective deferrals described in §402(g)(3) made on behalf of the employee under the employer's plan(s) for the tax year.[1188]

E. Contributions in Excess of the §402(g) Limit

Contributions in excess of the §402(g) limit are referred to as "excess deferrals."

For purposes of the qualification requirements, elective deferrals that exceed the §402(g) limit, and any allocable income, must be distributed from the plan by April 15 following the end of the tax year.[1189]

> *Example:* If an individual with a calendar year tax year makes excess deferrals in 2020, the excess deferrals and any income attributable to the deferral must be distributed by April 15, 2021. This deadline is not postponed by ex-

[1178] §402A(e)(9), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §127(e), effective for tax years beginning after December 31, 2023.

[1179] DOL, Frequently Asked Questions: Pension-Linked Emergency Savings Accounts, Q&A-6 (released January 17, 2024).

[1180] Reg. §1.402(g)(3)-1. Oddly, such amounts are subject to employment taxes, notwithstanding that they are treated as employer contributions. *See* Reg. §31.3121(a)(5)-2.

[1181] §402(g)(3) (flush language); Reg. §1.402(g)-1(c).

[1182] 1986 Conf. Rep. II-405 and 420; *see also* PLR 8746080.

[1183] *See* PLR 201601012. *See also* TAM 9635002.

[1184] *See* SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §603(b)(1) (eliminating §402(g)(1)(C), effective for tax years beginning after December 31, 2023).

[1185] Notice 2023-62. For current and prior year §402(g) limits, see the cost of living adjustments applicable to §401(k) plans in the Worksheets.

[1186] §402(g)(8), effective for tax years beginning after December 31, 1997. For tax years beginning before 1998, such matching contributions generally were subject to the §402(g) limit on the theory that a self-employed individual was effectively making a choice between cash or deferral when the individual chose whether to make an elective deferral subject to a matching contribution.

[1187] §401(a)(30); Reg. §1.401(a)-30.

[1188] §6051(a)(8); *see* Notice 89-32.

[1189] Reg. §1.402(g)-1(e)(1)(i).

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tending the filing of the individual's federal income tax return.

For purposes of the individual limitations, if the elective deferrals of an individual exceed the §402(g) limit for his or her tax year, the excess elective deferrals are included in that individual's gross income.[1190] However, to the extent the excess elective deferrals are Roth elective deferrals, they are not includible in gross income because they were, by definition, already included in gross income.[1191] In addition, if the individual is eligible for, and the plan permits, catch up contribution (see VIII., below) then to the extent the individual can make catch-up contributions, the excess deferral would not be included in gross income and would remain in the plan.

1. Tax Treatment of Excess Deferrals Under §402(g)

Elective deferrals for a tax year in excess of the §402(g) limit are included in the individual's gross income for the year.[1192] In addition, if the excess is not distributed by April 15 of the tax year following the tax year of the deferral, the individual does not have basis in the excess.[1193] In other words, the excess will be subject to double taxation, once in the year of the excess deferral and again when it is distributed from the plan.

> *Example:* An individual with a calendar year tax year makes excess deferrals in 2020. If the excess deferrals and any income attributable to the deferral are not distributed by April 15, 2021, the individual will be taxed on the deferral in 2020 and taxed again in 2021. See VII.E.2.e., below, for rules on how income attributable to the deferral is taxed.

Excess deferrals are to be treated as employer contributions for other purposes of the Code, including §401(a)(4), §401(k)(3), §404, §409, §411, §412, and §416.[1194] This is true even if the excess deferrals are distributed from the plan on or before the next April 15.[1195] Excess deferrals are counted under the ADP test, with the exception of excess deferrals of non-highly compensated employees that are determined by the employer to be excess deferrals without taking into account any deferrals through other employers.[1196] Finally, unless distributed on or before the next April 15, excess deferrals count as employer contributions for purposes of the §415 limits on annual additions and, if they are CODA contributions, become subject to the restrictions on distributions of elective deferrals under §401(k)(2)(B)(1) (i.e., generally, a distribution may not be made before severance from employment, death, disability, age 59½, hardship, or plan termination).[1197]

Since elective deferrals through other employers will count against the §402(g) limit, it is impossible for any one employer to know precisely when the limit has been exceeded, for purposes of withholding federal income tax from the excess deferrals. Once the limit is exceeded by deferrals through a single employer, however, that employer must begin withholding federal income tax.[1198] For this purpose, related employers must be aggregated and treated as a single employer to the extent required by §414(b), §414(c), §414(m), or §414(o), so that elective deferrals through two or more such employers must be taken into account in determining whether the §402(g) limit has been reached.[1199]

2. Return of Excess Deferrals Under §402(g)

If an individual has made excess deferrals for a tax year, the individual may, no later than March 1 following the end of the tax year in which the excess deferrals were made, allocate the excess deferrals among the plans under which they were made and notify each plan of the portion allocated to it.[1200] The notice must identify the extent, if any, to which the excess deferrals include designated Roth contributions, if applicable.[1201]

Each plan may then distribute to the individual, no later than April 15 following the end of the tax year, the amount of the excess allocated to it (and any income allocable to that amount).[1202]

Practice Insight: While a plan "may" distribute excess deferrals that result because an individual participant contributes to two or more plans of unrelated employers, the qualification rules of §401(a)(30) effectively require that a plan distribute excess deferrals at least with respect to excesses that occur as a result of aggregating deferrals among an employer's own plans.

a. Plan Terms Permitting Distribution of Excess Deferrals Under §402(g)

A plan need not provide for the distribution of excess deferrals, but the regulations require a plan to contain language permitting distributions if distributions are to be made.[1203]

Practice Insight: Practically speaking, a plan will want to include terms that allow it to distribute excess deferrals so that the plan may avoid disqualification by failing to meet the qualification requirements of §402(g).

If a plan permits distributions, such a distribution may be made notwithstanding any other provision of law,[1204] and without regard to any consents by the participant or spouse that might otherwise be required.[1205] The distribution may also be made notwithstanding any contrary qualified domestic relations order under §414(p),[1206] but is not counted toward any minimum required distributions under §401(a)(9).[1207]

1190 §402(g)(1)(A).
1191 §402(g)(1)(A).
1192 §402(g)(1).
1193 §402(g)(6); Reg. §1.402(g)-1(e)(8)(iii).
1194 Reg. §1.402(g)-1(e)(1)(ii).
1195 Reg. §1.402(g)-1(e)(1)(ii).
1196 §402(g)(2)(B); Reg. §1.402(g)-1(e)(1)(ii).
1197 Reg. §1.402(g)-1(e)(1)(ii), §1.402(g)-1(e)(8)(iii).
1198 Notice 87-13, Q&A-10.
1199 Notice 87-13, Q&A-10.
1200 §402(g)(2)(A)(i).
1201 Reg. §1.402(g)-1(e)(2)(i).
1202 §402(g)(2)(A)(ii). *See generally* Reg. §1.402(g)-1(e)(2).
1203 Reg. §1.402(g)-1(e)(4).
1204 §402(g)(2)(A) (flush language).
1205 Reg. §1.402(g)-1(e)(7).
1206 1986 Conf. Rep. II-387.
1207 Reg. §1.402(g)-1(e)(9).

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b. Notification of Plan Administrator Regarding Excess Deferrals Under §402(g)

A plan may provide that an individual is deemed to have notified the employer or plan administrator of excess deferrals if the sum of the elective deferrals made under all plans sponsored by the employer exceeds the §402(g) limit.[1208] Alternatively, a plan may provide that the employer may notify the plan administrator on the individual's behalf in this situation.[1209] This default notification system may include a designation of the portion of excess deferrals that are designated Roth contributions.[1210] Thus, a plan may provide that excess deferrals are in the first instance comprised of designated Roth contributions if an employee has made both pre-tax and Roth elective deferrals. Notwithstanding the above, if excess deferrals under §402(g) are distributed to a participant, such distributions must first come from the participant's pension-linked emergency savings account ("PLESA") to the extent contributions were made to the PLESA during the applicable tax year.[1211]

Practice Insight: At least one of the alternative notification methods described above is probably required as a practical matter, since §401(a)(30) requires, as a matter of plan qualification, that a plan not permit the §402(g) limits to be exceeded. As compliance with §401(a)(30) is determined without regard to excess deferrals distributed by April 15,[1212] the burden of monitoring its own plans for §402(g) excesses has been shifted to the employer. Thus, while a plan need not provide for distribution of excess deferrals where the individual participant contributes to two or more plans of unrelated employers, the qualification rules of §401(a)(30) effectively require that a plan have adequate provisions allowing for distribution of excess deferrals at least with respect to excesses that occur as a result of aggregating deferrals among an employer's own plans.

c. Year of Inclusion of Excess Deferrals Under §402(g)

If the excess deferral is distributed by the April 15 deadline, it will not be included in gross income in the year it is distributed, and will not be subject to the 10% early distribution tax if the individual is under age 59½.[1213] Instead, the excess deferral is included in gross income for the year of the deferral. However, any income on the excess deferral is included in the year of distribution. See VII.E.2.e., below.

A plan may also provide that an individual who has excess deferrals may receive a corrective distribution during the same year in which the excess deferrals are made.[1214] Both the plan and the individual must "designate" the distribution as an excess deferral, (and the portion comprised of designated Roth contributions) and the distribution must be made after the excess deferral has been received by the plan. A plan may provide that an individual is deemed to provide the necessary designation or may itself designate the distribution on behalf of the individual.[1215]

d. Limitations on Amount Distributed as an Excess Deferral Under §402(g)

The amount of excess deferrals which may be distributed for an employee's tax year is reduced by any excess contributions caused by an ADP test failure previously distributed or recharacterized for that employee for the plan year beginning with or within such tax year.[1216] Furthermore, an individual may not receive more corrective distributions for a tax year than the total amount of his or her elective deferrals under the plan for that year (plus income).[1217]

e. Income on Excess Deferrals Under §402(g)

In general, any income allocable to a distributed excess deferral must be distributed with it.[1218] The allocable income is treated as earned and received in the tax year of the distribution.[1219]

The regulations set forth the method of computing income on excess deferrals.[1220] As with distributions of excess contributions caused by an ADP test failure, the plan may use any reasonable method for computing the gain or loss allocable to excess deferrals, provided that such method does not violate §401(a)(4), is used consistently for all participants and for all corrective distributions under a plan for that plan year, and is used by the plan for allocating income to participants' accounts.[1221] A plan may also use an alternative method, under which the allocable income is that portion of the income allocable to elective deferrals multiplied by the ratio of the amount of excess deferrals for the tax year to the sum of those excess deferrals plus the total account balance of the employee attributable to elective deferrals as of the beginning of the tax year.[1222]

Allocable income is only calculated through the end the tax year and does not include income earned after the end of the taxable period prior to the distribution.[1223]

> *Example:* A participant's tax year is the calendar year. The participant's elective deferrals exceed the §402(g) limit in 2019. Excess deferrals are distributed April 10, 2020. Income earned from January 1, 2020, through April 10, 2020, is not taken into account for purposes of calculating allocable income that must be distributed.

Practice Insight: For tax years beginning before 2007, allocable income included only income earned through the end of the tax year and, unless provided for by the plan, did not include income earned after the end of the tax year and prior to the distribution.[1224] Under amendments to the regulations effective for tax years beginning on or after January 1, 2007, allo-

[1208] Reg. §1.402(g)-1(e)(2)(i), §1.402(g)-1(e)(3)(i)(A).
[1209] Reg. §1.402(g)-1(e)(2)(i), §1.402(g)-1(e)(3)(i)(A).
[1210] Reg. §1.402(g)-1(e)(2)(i).
[1211] Reg. §1.402(g)-1(e)(2)(i). For a discussion of PLESAs, see V.B.5., above.
[1212] Reg. §1.402(g)-1(e)(1)(i). *See* Reg. §1.401(a)-30.
[1213] §402(g)(2)(C); Reg. §1.402(g)-1(e)(8)(i).
[1214] Reg. §1.402(g)-1(e)(3)(i).
[1215] Reg. §1.402(g)-1(e)(3)(i)(A).
[1216] Reg. §1.402(g)-1(e)(6).
[1217] §402(g)(2)(A)(ii); Reg. §1.402(g)-1(e)(6).
[1218] Reg. §1.402(g)-1(e)(5).
[1219] Reg. §1.402(g)-1(e)(8)(i).
[1220] Reg. §1.402(g)-1(e)(5).
[1221] Reg. §1.402(g)-1(e)(5)(ii).
[1222] Reg. §1.402(g)-1(e)(5)(iii).
[1223] §402(g)(2)(A)(ii).
[1224] Reg. §1.402(g)-1(e)(5), as it appeared in the pre-2007 regulations.

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cable income also includes the income earned after the end of the tax year.[1225] This rule, however, was in tension with a provision of the 2006 PPA which eliminated income earned after the end of the tax year from the definition of allocable income for purposes of distributing excess contributions under the ADP test.[1226] In response, Congress expressly limited distributable income to income earned prior to the end of the tax year in the Worker, Retiree, and Employer Recovery Act of 2008 (WRERA), effective as if it were included in the 2006 PPA.[1227] As a result, the limitation to income earned through the end of the tax year is effective for tax years beginning after 2007, leaving only the 2007 tax year as a year for which income earned after the end of the tax year had to be distributed.

"Income" must take into account any allocable losses.[1228]

Practice Insight: The effect of this rule is that while an employee is taxable on the full amount of the excess in the year in which the excess deferral was made, the actual amount returned may be smaller if investment results produce a net loss. If the excess deferral is returned during the year in which it was made, the loss may be used to offset gross income for that year.[1229] If the corrective distribution is made by April 15 of the following year, however, the loss is used to offset gross income in the year of the corrective distribution.[1230]

[1225] Reg. §1.402(g)-1(e)(5)(i), as amended by T.D. 9324, 72 Fed. Reg. 21,103 (Apr. 30, 2007).

[1226] Pub. L. No. 109-280, §902(e)(3)(B)(i).

[1227] Pub. L. No. 110-458, §109(b)(3), amending §402(g)(2)(A)(ii).

[1228] Reg. §1.402(g)-1(e)(5)(i).

[1229] Notice 89-32.

[1230] Notice 89-32.

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VIII. Catch-Up Contributions

A plan may allow an individual age 50 or older to make additional elective deferrals in excess of the §402(g) limits, if certain requirements are satisfied.[1231] These additional elective deferrals are typically referred to as "catch-up contributions."

Practice Insight: Although the additional amounts are referred to as "catch-up contributions," an individual's ability to make them is not conditioned upon any showing that the individual previously undercontributed to the plan or did not contribute the maximum.

Catch-up contributions are not subject to any otherwise applicable limitations on elective deferrals, including the elective deferrals limit under §402(g) and the limit on annual contributions under §415(c). Catch-up contributions are also not subject to ADP testing, and are treated as meeting the nondiscrimination requirements of §401(a)(4),[1232] so long as catch-up contributions are available to all eligible individuals who participate under any plan maintained by the employer that provides for elective deferrals.[1233]

A. Eligibility to Make §414(v) Catch-Up Contributions

A participant who is eligible to make elective deferrals under an applicable plan is eligible to make catch-up contributions if he or she will be 50 or older before the end of his or her tax year (almost invariably the calendar year).[1234] As a result, a participant whose 50th birthday will occur at any time during a calendar year is eligible to make catch-up contributions beginning January 1 of that year.

B. Plans Eligible to Allow for §414(v) Catch-Up Contributions

Catch-up contributions can be made to any §401(k) plan, SIMPLE IRA, SEP, §403(b) plan, or a governmental §457(b) plan that permits elective deferrals, and that allows for catch-up contributions pursuant to its terms.[1235] For this purpose, any contribution to a governmental §457 plan is treated as an elective deferral.[1236]

C. Maximum Dollar Amount of §414(v) Catch-Up Contributions

The maximum amount of annual catch-up contributions is $5,000, as adjusted for inflation.[1237] In addition to the explicit dollar limit, the catch-up contribution when added to all other elective deferrals for the tax year cannot exceed the participant's compensation (determined under §415(c)(3)) for the tax year.[1238]

A special dollar limit applies to SIMPLE 401(k) plans and SIMPLE IRAs, which generally are subject to lower contribution limits. The maximum amount of annual catch-up contributions in a SIMPLE 401(k) or SIMPLE IRA is $2,500, as adjusted for inflation.[1239]

However, effective for taxable years beginning on or after January 1, 2025:

- For non-SIMPLE plans, the maximum amount of annual catch-up contributions for a participant who would attain age 60 but would not attain age 64 before the end of the year (i.e., participants age 60-63), is the greater of (1) $10,000, or (2) 150% of the standard catch-up contribution amount set for the year 2024.[1240] These amounts will be adjusted for inflation annually beginning in 2026.[1241]

- For SIMPLE plans, the maximum amount of annual catch-up contributions for a participant who would attain age 60 but would not attain age 64 before the end of the year (i.e., participants age 60-63), is the greater of (1) $5,000, or (ii) 150% of the standard catch-up contribution amount set for the year 2025.[1242] These amounts will be adjusted for inflation annually beginning in 2026.[1243]

According to the IRS, plans are not required to provide for a higher applicable dollar catch-up limit for participants at age 60 through age 63.[1244]

Practice Insight: The maximum amount of catch-up contributions is not necessarily measured on the participant's tax year or the plan year, and instead is measured based on the applicable limit that the catch-up contribution exceeds. See VIII.E., below, for information regarding how to calculate the catch-up contribution and apply the maximum dollar amount each year.

D. Section 414(v) Catch-Up Contributions Interaction with §457 and §403(b) Catch-Up Contributions

There are two "catch-up" contributions under the I.R.C. other than the §414(v) catch-up: the §457 catch-up[1245] and the §403(b) catch-up,[1246] both of which apply to long-service employees. These other two catchups are true catch-ups in the sense that they depend on whether the employee underutilized the contribution limits in prior years. A participant is not entitled to both the §414(v) and §457 catch-up in a single year, but

[1231] §414(v).

[1232] §414(v)(3).

[1233] §414(v)(4)(A). *See* VIII.H., below.

[1234] §414(v)(5); Reg. §1.414(v)-1(g)(3).

[1235] §414(v)(1); §414(v)(6)(A); Reg. §1.414(v)-1(g)(1).

[1236] Reg. §1.414(v)-1(g)(2).

[1237] §414(v)(2)(B)(i), §414(v)(2)(C). The limit is adjusted for inflation in $500 increments in the same manner as the §402(g) limit. For the current and previous dollar amounts, see the Worksheets.

[1238] §414(v)(2)(A)(ii).

[1239] §414(v)(2)(B)(ii), §414(v)(2)(C). The limit is adjusted for inflation in $500 increments in the same manner as the §402(g) limit. For the current and previous dollar amounts, see the Worksheets.

[1240] §414(v)(2)(B)(i), as amended by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §109(a)(1), applicable to taxable years beginning after December 31, 2024. *See* §414(v)(2)(E), as added by Pub. L. No. 117-328, Div. T, §109(b), applicable to taxable years beginning after December 31, 2024. *See also* Prop. Reg. §1.414(v)-1(c)(2)(ii)(B), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025).

[1241] §414(v)(2)(C), as amended by Pub. L. No. 117-328, Div. T, §109(c), applicable to taxable years beginning after December 31, 2024.

[1242] *See* §414(v)(2)(B)(ii), as amended by Pub. L. No. 117-328, Div. T, §109(a)(2), applicable for taxable years beginning after December 31, 2024. *See also* §414(v)(2)(E), as added by Pub. L. No. 117-328, Div. T, §109(b), applicable for taxable years beginning after December 31, 2024.

[1243] §414(v)(2)(C), as amended by Pub. L. No. 117-328, Div. T, § 109(c), applicable to taxable years beginning after December 31, 2024.

[1244] *See* REG-101268-24, 90 Fed. Reg. at 2649 n.6.

[1245] §457(b)(3).

[1246] §402(g)(7).

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rather is entitled to the greater of the two catch-ups.[1247] In contrast, however, a participant may benefit from both the §414(v) catch-up and the §403(b) catch-up in the same year, thereby contributing the sum of the two catch-ups.[1248]

E. Determination of a §414(v) Catch-Up Contribution

A catch-up contribution is an elective deferral made by a participant eligible to make catch-up contributions that exceeds any of the limits described below.[1249] A catch-up contribution is determined at the end of the calendar or plan year, whichever is applicable to the limit which has been exceeded. In other words, a contribution will not be considered a catch-up contribution until it exceeds one of the applicable limits described below.

(1) *Statutory Limits.* A catch-up contribution may be created by exceeding any of the statutory limits on elective deferrals or annual additions provided in §401(a)(30), §402(h), §403(b), §408, §415(c), or §457(b)(2) (without regard to §457(b)(3), which provides the §457 catch-up).[1250] This means that a catch-up eligible participant may make elective deferrals that exceed the §402(g) limit. It also means a participant may receive total contributions that exceed the §415(c) limit.

(2) *ADP Limit.* A plan that provides for elective deferrals must satisfy the ADP test. As further described in III.M., above, one way for a plan to correct an ADP test failure is to distribute the excess contributions to highly compensated participants according to §401(k)(8). Therefore, the ADP limit is the highest amount of elective deferrals that can be retained on behalf of a highly compensated employee, if the plan corrects an ADP test failure by distributing excess contribution under §401(k)(8).[1251]

The ADP test and catch-up contributions interact in two ways. First, catch-up contributions are not taken into account in calculating an employee's actual deferral ratio (ADR).[1252] That is, catch-up contributions are subtracted from an employee's elective deferrals before the ADR is determined.

Practice Insight: All other limits should be applied to an elective deferral prior to application of the ADP limit since such catch-up contributions are not taken into account in determining an employee's ADR. Therefore, the application of the ADP limit should be the final step in calculating catch-up contributions.

In addition, the ADP test itself is an applicable limit, and therefore, excess contributions may also be catch-up contributions.[1253] However, because catch-up contributions may exceed the ADP limit, the excess contributions that qualify as catch-up contributions do not need to be distributed in order for the plan to correct its ADP test failure via distribution of excess contributions under §401(k)(8).[1254]

Example: Catch-up eligible participant T is a highly compensated employee (HCE) and makes elective deferrals of $17,000 in a year in which the §402(g) limit is $15,000. Of that amount, $2,000 is not taken into account in performing the ADP test. Assuming that the highest amount that can be retained by T as an HCE under the ADP limit is $12,000, the additional $3,000 would be treated as an excess contribution. However, it also is a catch-up contribution and therefore could be retained under the plan.

A matching contribution on an excess contribution that is a catch-up contribution is subject to the permitted forfeiture rules of §411(a)(3)(G), which allows for forfeiture notwithstanding that the participant is fully vested under the plan.[1255] However, the plan terms dictate whether matching contributions are made on excess contributions.

Practice Insight: The ADP limit is not relevant to a non-highly compensated employee because the ADP test does not limit the elective deferrals that a non-HCE may make.

(3) *Plan Limit.* The third limit is any limit imposed by the terms of the plan but which is not required under the Code.[1256] The classic example of a plan-imposed limit is a plan provision that restricts elective deferrals to no more than 10% of compensation as a prophylactic measure intended to head off ADP testing problems. Such a plan may permit catch-up contributions in excess of the 10% of compensation limit.

The regulations state that a plan limit must be "contained in the terms of the plan" so that an administratively imposed limit may not be considered a plan limit.[1257] The outer bounds of this rule are not entirely clear, although it seems reasonable to treat a limit declared by a plan administrative committee pursuant to an express delegation of authority under the plan document as a plan limit, at least to the extent the declaration is in writing.

As described further under VIII.C., above, if a plan permits catch-up contributions for any participants, they must be available to all participants that are otherwise eligible. There is some tension between this "universal availability" requirement and the notion of an employer-imposed plan limit. However, this is generally resolved by providing, for example, that elective deferrals may not exceed 10% of compensation but that the plan permits catch-up contributions above and beyond such limit.

Practice Insight: Taken literally, the universal availability requirement applicable to catch-up contributions would disallow a plan from imposing an elective deferral limit of 0% on highly compensated employees since such employees would not be eligible to make elective deferrals and, therefore, could not qualify as catch-up eligible participants. However, a plan may impose a very low limit on HCE elective deferrals, in which case virtually all elective deferrals of HCEs would not

[1247] §414(v)(6)(C); Reg. §1.414(v)-1(a)(3).
[1248] Reg. §1.403(b)-4(c)(3)(iv).
[1249] Reg. §1.414(v)-1(a)(1).
[1250] Reg. §1.414(v)-1(b)(1)(i).
[1251] Reg. §1.414(v)-1(b)(1)(iii).
[1252] Reg. §1.414(v)-1(d)(2).
[1253] Reg. §1.414(v)-1(d)(2)(iii).
[1254] Reg. §1.414(v)-1(d)(2)(iii).
[1255] Reg. §1.414(v)-1(d)(2)(iii).
[1256] Reg. §1.414(v)-1(b)(1)(ii).
[1257] Reg. §1.414(v)-1(b)(1)(ii).

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be taken into account in applying the ADP test, thereby effectively guaranteeing that the plan would pass the test, as well as ensuring that such HCEs could qualify as catch-up eligible participants.

The regulations accommodate plan limits that are imposed for a portion of a year, for example, a plan that limits elective deferrals on a payroll basis to 10% of compensation.[1258] In such a case, the limit applicable to the catch-up contributions is the sum of the dollar amounts of the limits for the separate payroll periods.[1259] There is also a special rule that allows a plan to determine the plan limit that is imposed for a portion of a year using the time-weighted average of the deferral limits.[1260]

Practice Insight: This rule may be useful where the employer changes a deferral limit during the year as it obtains preliminary ADP test results.

> *Example:* A plan limits HCE elective deferrals to 10% of compensation for the first half of the year and 8% of compensation for the second half of the year. In this case, the plan may treat the plan limit for the year as 9% of compensation.[1261]

Catch-up contributions are easily determined if the plan uses the calendar year as its plan year and limitation year. The applicable limits are applied at the end of the plan year by comparing the total elective deferrals for the plan year with the applicable limit for the plan year.[1262] However, the determination of catch-up contributions is more complicated if the plan has a non-calendar year plan year or limitation year. The basic rule is that if an applicable limit applies on a basis other than the plan year, then the determination of whether the limit has been exceeded is made on the basis of the other year.[1263]

> *Example:* If a plan has a July 1 to June 30 plan year, the determination of whether elective deferrals are in excess of the §402(g) limit is made at the end of the calendar year since the §402(g) limit is generally a calendar year limit.

Practice Insight: One should not underestimate the complexity associated with identifying catch-up contributions where a plan has a non-calendar year plan year or limitation year.

F. Treatment of Catch-Up Contributions as Elective Deferrals

Catch-up contributions are elective deferrals.[1264]

There are two possible methods for making catch-up contributions. A plan may provide for separate elections with respect to "regular" elective deferrals and catch-up contributions. Alternatively, a plan may prescribe a single election, with the determination of whether a portion of the elective deferrals are catch-up contributions being made under the terms of the plan.[1265] The latter appears to be the norm.

As elective deferrals, catch-up contributions are subject to the same general rules that apply to other elective deferrals, including the distribution and vesting restrictions of §401(k)(2)(B) and §401(k)(2)(C).[1266] Catch-up contributions are not taken into account in applying the limits of §401(a)(30), §402(h), §403(b), §408, §415(c), or §457(b)(2) (without regard to §457(b)(3)) to other contributions under the plan.[1267]

For purposes of determining the account balance of a participant for purposes of the average benefit percentage test under §410(b) and top-heavy status under §416, catch-up contributions are not taken into account with respect to the current plan year, but are taken into account for prior years.[1268] Thus, there is no separate accounting requirement for catch-up contributions after such contributions have been made.

G. Roth Catch-Up Contributions for High-Earning Participants

For tax years beginning on or after January 1, 2024, participants with more than $145,000 in wages for the preceding calendar year will be required to make any catch-up contributions as Roth contributions under §414(v)(7).[1269] Notice 2023-62 provides a two-year administrative transition period, delaying the Roth contribution catch-up requirement until tax years beginning on or after January 1, 2026. During the administrative transition period, catch-up contributions are treated as satisfying the Roth catch-up contribution requirements, even if contributions are not designated as Roth contributions and a plan does not provide for designated Roth contributions.[1270] Under a proposed rule issued in January 2025, regulations would apply with respect to contributions in taxable years beginning more than six months after the issuance of final regulations adding rules for catch-up contributions that must be designated Roth contributions under §414(v)(7). For applicable employer plans maintained pursuant to collective bargaining agreements, the regulations would apply with respect to contributions in taxable years beginning after the later of the first taxable year described above or the first taxable year that begins after the date on which the last collective bargaining agreement related to the plan that is in effect on December 31, 2025, terminates (without regard to extensions).[1271]

Participants exceeding the $145,000 income threshold will not be able to make catch-up contributions as traditional pre-tax contributions, but will instead be required to make catch-up contributions as designated Roth contributions.[1272] This income

[1258] Reg. §1.414(v)-1(b)(2)(i)(A).
[1259] Reg. §1.414(v)-1(b)(2)(i)(A).
[1260] Reg. §1.414(v)-1(b)(2)(i)(B).
[1261] Reg. §1.414(v)-1(b)(2)(i)(B)(1).
[1262] Reg. §1.414(v)-1(b)(2)(i)(A), §1.414(v)-1(c)(3).
[1263] Reg. §1.414(v)-1(b)(2)(ii).
[1264] Reg. §1.414(v)-1(a)(2).

[1265] Reg. §1.414(v)-1(a)(2).
[1266] Reg. §1.414(v)-1(a)(2).
[1267] Reg. §1.414(v)-1(d)(1).
[1268] Reg. §1.414(v)-1(d)(3).
[1269] §414(v)(7), added by the SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §603(a), effective for taxable years beginning after December 31, 2023. The rule does not apply to SEPs or SIMPLE retirement accounts. §414(v)(7)(C).
[1270] Notice 2023-62.
[1271] REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025); *see* Prop. Reg. §1.414(v)-2(e)(2). The definitions in Reg. §1.414(v)-1(g) (e.g., applicable employer plan, catch-up eligible participant) would apply to the rules for catch-up contributions that must be designated Roth contributions under §414(v)(7). *See* Prop. Reg. §1.414(v)-1(a)(1), REG-101268-24.
[1272] §414(v)(7)(A). *See* Prop. Reg. §1.414(v)-2(a)(3), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025).

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threshold is indexed annually for inflation, rounded to the lowest multiple of $5,000.[1273]

If an eligible participant received $145,000 or less in FICA wages for the preceding calendar year, then any catch-up contributions that are made to the plan on behalf of the participant are not required to be designated as Roth contributions.[1274] Under the proposed rule, the Roth catch-up wage threshold would not be required to be prorated for the first year of employment with the employer.[1275] Any catch-up contributions under §414(v) that are made to the plan on behalf of the participant that are not designated as Roth contributions are not includible in the participant's gross income under §402(g)(1)(A) because the limitation on elective deferrals under §401(a)(30) do not apply to those catch-up contributions.[1276]

In 2023, the IRS indicated that it expected to issue additional guidance that, in part, would provide that the Roth catch-up would not be required for a participant who does not have FICA wages for the preceding calendar year from the employer sponsoring the plan (for example, the individual had been a partner receiving self-employment income or a nonfederal government employee whose services were excluded from employment under §3121(b)(7)).[1277] Under the proposed rule issued in January 2025, the Roth catch-up would not be applied in a current year to participants with FICA wages not exceeding $145,000 (as adjusted) from the employer sponsoring the plan in the preceding calendar year.[1278] Thus, for example, the Roth catch-up would not be required for partners receiving only self-employment income, nor would it be required for individuals whose compensation was taxed under FICA in an earlier year because of the deferred compensation rules under §3121(v)(2). The Roth catch-up also would not be required for state or local government employees whose services are excluded from employment under §3121(b)(7), without regard to §3121(u) or for individuals with wages subject to the Railroad Retirement Tax Act under §3231(e).[1279]

In determining whether a plan participant meets the income threshold, the employer sponsoring the plan would be the participant's common law employer that is contributing to the plan.[1280] If multiple employers sponsor the plan (i.e., through aggregation or it is a multiple employer plan or a multiemployer plan), wages from each employer would not be aggregated to determine whether the participant's wages for the preceding calendar year exceeded the Roth catch-up wage threshold.[1281]

If a plan provides that additional elective deferrals for participants whose FICA wages exceed the Roth catch-up contribution wage threshold must be are designated Roth contributions, the plan must permit other catch-up eligible plan participants to make their additional elective deferrals as designated Roth contributions in addition to traditional, pre-tax §401(k) contributions.[1282] Under the proposed rule issued in January 2025, a plan that does not have a qualified Roth contribution program would not be precluded from permitting catch-up contributions for eligible participants who are not subject to the Roth catch-up requirement. The catch-up contribution for participants subject to the Roth catch-up requirement would be $0.[1283]

In 2023, the IRS also indicated that it expected to issue additional guidance that, in part, would provide that, if the Roth catch-up is required for a participant, the employer could treat the participant's election to make catch-up contributions on a pre-tax basis as an election to make catch-up contributions that are designated Roth contributions.[1284] Under the proposed rule issued in January 2025, a plan would be permitted to provide, for taxable years beginning after December 31, 2023, that a participant who is subject to the Roth catch-up requirement is deemed to have irrevocably designated catch-up contributions as designated Roth contributions. The plan's ability to provide for a deemed Roth catch-up election would not depend on whether the plan requires separate elections for elective deferrals that are not catch-up contributions and for additional elective deferrals that are catch-up contributions, as long as the participant would have an effective opportunity to make a new election that differs from the deemed election.[1285]

Questions have arisen as to whether the timing of designated Roth contributions would affect satisfaction of the Roth catch-up contribution requirement. Under the proposed rule, designated Roth contributions made during the year before a limit is reached would be taken into account in determining whether the Roth catch-up requirement is met. Thus, a participant would comply with the Roth catch-up requirement as long as the participant's total elective deferrals that are designated Roth contributions over the year equal or exceed the total elective deferrals that are determined to be catch-up contributions.[1286]

Practice Insight: Given the challenge and complexity involved in tracking the pay of each participant, and to ease administrative burdens, employers might consider requiring that all catch-up contributions be made as Roth contributions.

If a catch-up eligible participant who is subject to the Roth catch-up requirement makes a pre-tax elective deferral that exceeds an applicable limit, the plan must correct the failure to avoid loss of the age 50 and older catch-up contribution for that elective deferral and the plan's loss of qualified status. The IRS proposed alternative correction methods that would permit a plan to correct a failure to satisfy the Roth catch-up require-

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[1273] §414(v)(7)(E). *See* Prop. Reg. §1.414(v)-2(a)(3). For the adjusted dollar amount, see the Worksheets.

[1274] Notice 2023-62.

[1275] Prop. Reg. §1.414(v)-2(a)(2).

[1276] *See* §414(v)(3)(A)(i); Notice 2023-62.

[1277] Notice 2023-62.

[1278] Prop. Reg. §1.414(v)-2(a)(2).

[1279] *See* REG-101268-24, 90 Fed. Reg. at 2649 (preamble).

[1280] Prop. Reg. §1.414(v)-2(b)(3).

[1281] Prop. Reg. §1.414(v)-2(b)(4); *see* Prop. Reg. §1.414(v)-2(d)(4) (example).

[1282] §414(v)(7)(B). *See* Prop. Reg. §1.414(v)-2(a)(5)(i). If a dual-qualified plan covers employees in the United States and in Puerto Rico and allows any catch-up eligible participant in the United States who is subject to the Roth catch-up requirement to make catch-up contributions as designated Roth contributions for a plan year, the plan would be treated as satisfying §414(v)(7)(B) for a catch-up eligible participant who is subject to Puerto Rico I.R.C. §1081.01 if the plan permits the participant to make catch-up contributions as after-tax contributions within the meaning of PRIRC §1081.01(a)(15). Prop. Reg. §1.414(v)-2(a)(5)(ii).

[1283] *See* Prop. Reg. §1.414(v)-2(b)(2).

[1284] Notice 2023-62.

[1285] Prop. Reg. §1.401(k)-1(f)(5)(iii), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025).

[1286] Prop. Reg. §1.414(v)-2(b)(1); *see* REG-101268-24, 90 Fed. Reg. at 2650-51 (preamble).

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ment under §414(v)(7) other than by distributing excess elective deferrals: the Form W-2 correction method; and the in-plan Roth rollover correction method. A plan would be permitted to apply either method, but would have to apply the same correction method for all participants with elective deferrals in excess of the same applicable limit for the plan year.[1287]

H. Nondiscrimination and Universal Availability Requirements for Catch-Up Contributions

Catch-up contributions are not subject to the general nondiscrimination rules.[1288] The regulations specify that the class of participants who are eligible for catch-up contributions need not be a class that would satisfy the nondiscriminatory classification test of §410(b).[1289] Similarly, the mere fact that only catch-up eligible participants may make catch-up contributions is not tested as a benefit, right, or feature under §401(a)(4).[1290] However, an employer that offers catch-up contributions will be treated as failing to meet nondiscrimination requirements under §401(a)(4) unless the plan allows all eligible participants the same effective opportunity to elect catch-up contributions.[1291] This is referred to as the "universal availability" requirement. Put differently, an employer is not required to provide for catch-up contributions in any of its plans. If, however, any plan of the employer provides for catch-up contributions, all plans of the employer that provide elective deferrals must comply with the universal availability requirement.[1292]

For this purpose, all plans maintained by employers that are treated as a single employer under the §414(b), §414(c), §414(m), or §414(o) controlled group rules are treated as a single plan under the universal availability requirement.[1293] There is no exception for a qualified separate line of business under §414(r).

Plan-specific limits may not effectively prohibit a catch-up eligible participant from making elective deferrals, and therefore catch-up contributions.[1294] The mere fact, however, that an employer-provided limit does not apply to all employees does not create a universal availability problem.[1295] A plan may not provide a lower plan limit for catch-up eligible participants.[1296]

Practice Insight: An interesting question is whether a plan limit that has a fixed-dollar cap would satisfy the effective opportunity requirement. In this regard, expressed as a percentage of pay the applicable limit would be higher for lower paid employees relative to highly paid employees.

There are a number of clarifications and exceptions to the universal availability rule:

- Collectively bargained employees and nonresident aliens are disregarded for purposes of the rule.[1297]
- A plan does not fail the universal availability requirement merely because it determines catch-up contributions on a payroll period or other prorated basis.[1298]
- A plan may impose a cash availability requirement.[1299] That is, a plan may restrict catch-up contributions to the extent an employee does not have amounts available to defer to the plan after payroll withholdings, including taxes and benefit premiums. A plan may establish a simplified limit of a percentage of compensation that can be deferred under a plan. The regulations indicate that a limit of 75% or more of compensation will not violate the rule.
- A governmental employer does not have to offer catch-up contributions on a §457 plan merely because it offers catch-up contributions on a grandfathered §401(k) plan or a §403(b) plan.[1300]
- There is an exception to the rule where an employer acquires a plan in connection with a business acquisition or disposition described in Reg. §1.410(b)-2(f).[1301] The exception extends to the end of the period under §410(b)(6)(C).

I. Catch-Up Contributions for Participants in Multiple Plans

Unlike the §402(g) limit, the §414(v) catch-up limit does not apply on a taxpayer-by-taxpayer basis, but rather on an

[1287] Prop. Reg. §1.414(v)-2(c); *see* Prop. Reg. §1.414(v)-2(d)(5), §1.414(v)-2(d)(6) (examples).

[1288] §414(v)(3)(B). *See* Reg. §1.414(v)-1(d)(3).

[1289] Reg. §1.414(v)-1(d)(4). In the case of a plan that does not include a qualified Roth contribution program and that allows catch-up eligible participants who are not subject to the Roth catch-up requirement to make catch-up contributions, Reg. §1.414(v)-1(d)(4) would not apply. If any non-highly compensated employees are subject to the Roth catch-up requirement (because of differences in the wage thresholds), this could impact the results for the nondiscrimination test regarding the availability of catch-up contributions performed under Reg. §1.401(a)(4)-4. If it would help it to satisfy this nondiscrimination test, the plan would be permitted to preclude one or more catch-up eligible participants who are highly compensated employees under §414(q) and who are not subject to the Roth catch-up requirement from making catch-up contributions. Prop. Reg. §1.414(v)-2(b)(2)(ii), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025), generally proposed to apply with respect to contributions in taxable years beginning more than six months after final regulations adding Reg. §1.414(v)-2 are issued, with a special applicability date for plans maintained pursuant to collective bargaining agreements.

[1290] Reg. §1.414(v)-1(d)(4).

[1291] §414(v)(4)(A); Reg. §1.414(v)-1(e)(1)(i).

[1292] Reg. §1.414(v)-1(e)(1)(i). *But see* Notice 2002-4, §V (stating that an employee plan that permits catch-up contributions will not fail to satisfy the universal availability requirements solely because the employer maintains another plan qualified under Puerto Rico law that does not provide for such contributions). Under a proposed rule, a plan that covers employees in both the United States and Puerto Rico would not fail to meet the §401(a)(4) nondiscrimination requirement because the plan permits catch-up eligible participants whose catch-up contributions are subject to the limit set forth in Puerto Rico I.R.C. §1081.01(d)(7) to make catch-up contributions only up to that limit ($1,500 in 2025). The application of the limits for an employee who performs service for an employer both in Puerto Rico and the United States in a year remains under consideration. Prop. Reg. §1.414(v)-1(e)(1)(iii), REG-101268-24, 90 Fed. Reg. 2645 (Jan. 13, 2025), generally proposed to apply with respect to contributions in taxable years beginning more than six months after final regulations adding Reg. §1.414(v)-2 (for catch-up contributions that must be designated Roth contributions under §414(v)(7)) are issued, with a special applicability date for plans maintained pursuant to collective bargaining agreements. *See* REG-101268-24, 90 Fed. Reg. at 2649 (preamble).

[1293] §414(v)(4)(B); Reg. §1.414(v)-1(g)(4)(i), referring to the definition of employer under Reg. §1.410(b)-9.

[1294] Reg. §1.414(v)-1(e)(1)(i).

[1295] Reg. §1.414(v)-1(e)(1)(i).

[1296] Reg. §1.414(v)-1(e)(1)(i).

[1297] Reg. §1.414(v)-1(e)(2).

[1298] Reg. §1.414(v)-1(e)(1)(ii)(A).

[1299] Reg. §1.414(v)-1(e)(1)(ii)(B).

[1300] Reg. §1.414(v)-1(e)(3).

[1301] Reg. §1.414(v)-1(e)(4).

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employer-by-employer basis.[1302] As a result, a catch-up eligible participant that works for two unrelated employers may make catch-up contributions that in total exceed the general dollar limit on catch-up contributions.

Note: The IRS intends to issue guidance that an eligible participant's wages for the preceding calendar year from one participating employer would not be aggregated with the wages from another participating employer for purposes of determining whether the participant's wages for that year exceed $145,000 for the Roth contribution catch-up requirement under §414(v)(7).[1303]

If an employee is a participant in more than one plan of the employer that permits elective deferrals, the catch-up limit applies as if all of the plans of the employer are a single plan.[1304] Thus, an eligible participant's elective deferrals made to more than one plan during a tax year are aggregated and the total amount of the catch-up contributions is limited to the annual maximum dollar amount under §414(v)(2).[1305] For this purpose, the employer is the controlled group employer within the meaning of §414(b), §414(c), §414(m), or §414(o).[1306] If participation in two plans that are aggregated is sequential, the second plan may only treat as catch-up contributions amounts deferred up to the remaining limit.[1307] The applicable employer limit in such circumstances may be determined in any manner that is not inconsistent with the manner in which such amounts were actually deferred.[1308]

J. Reporting of Catch-Up Contributions

Employers are required to report participants' elective deferrals on Form W-2 in box 12 using Codes D through H and S. Catch-up contributions are reported in those totals.[1309]

1302 §414(v)(2)(D); Reg. §1.414(v)-1(f)(1).

1303 *See* Notice 2023-62.

1304 Reg. §1.414(v)-1(f)(1).

1305 The SECURE 2.0 Act's elimination of §402(g)(1)(C) for taxable years beginning after December 31, 2023, does not change this result. *See* Notice 2023-62.

1306 Reg. §1.414(v)-1(g)(4).

1307 Reg. §1.414(v)-1(f)(2).

1308 Reg. §1.414(v)-1(f)(3).

1309 Announcement 2001-93.

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IX. Nonqualified CODAs

A. Distinguishing a Qualified CODA from a Nonqualified CODA

A cash or deferred arrangement does not have to be a qualified CODA to be included in a profit-sharing, stock bonus, pre-ERISA money purchase pension, or rural cooperative plan, and the regulations specifically recognize this.[1310] The regulations define a nonqualified CODA as a cash or deferred arrangement that:

• Provides for the same cash or deferred election as a qualified CODA — a direct or indirect choice between having the employer provide an amount to the employee in cash (or some other taxable benefit) that is not currently available and contributing the amount to a trust (or provide an accrual or other benefit) under a plan that defers the employee's receipt of compensation[1311] (except that in the case of a qualified CODA, the choice cannot involve a taxable benefit other than cash (or its cash value));[1312]

• Satisfies all of the same timing requirements for the election that apply to a qualified CODA — amounts deferred are not currently available, contributions do not precede election to defer, and contribution does not precede services for which contribution relates;[1313] but

• Does not satisfy all of the other requirements that apply to a qualified CODA under §401(k) — most notably, the ADP test (or a safe harbor under §401(k)(11), §401(k)(12), or §401(k)(13)), the nonforfeitability requirement, the contingent benefit rule, and the distribution limitations, and the limitations on years of service required for participation (see list in I.C., above).[1314]

As discussed above, the regulations define a nonqualified CODA by reference to the definition of a "cash or deferred election" in the regulations and the failure of the arrangement to satisfy the requirements for a qualified CODA under §401(k). In contrast, the Code does not include a definition of a nonqualified CODA or refer to the concept, other than by negative implication in limiting all of the tax benefits of a CODA to an arrangement that is a qualified CODA under §401(k). Thus, the concept of a nonqualified CODA could be viewed as regulatory in nature.

B. Effect of a Nonqualified CODA on Employees

Elective contributions under a nonqualified CODA are includible in an employee's gross income at the time the cash or other taxable amount the employee would have received would have been includible in gross income (but for the election),[1315] which is generally the tax year in which the amount would have been paid directly to the employee. Thus, an employee's elective contributions to a nonqualified CODA are not made on a pre-tax basis and taxation cannot be deferred until distribution from the plan.

The inclusion of elective contributions in income applies to both highly compensated and non-highly compensated employees, even if the CODA fails to qualify solely because it fails to satisfy the ADP test of §401(k)(3).

Subsequent distributions of elective contributions under a nonqualified CODA are taxed under §72, either by §402(a) if the plan remains qualified, or §402(b) if the plan loses its qualification. In either case, an employee should not be taxed again on amounts already included in income.

C. Effect of a Nonqualified CODA on the Tax-Qualified Status of a Plan

A profit-sharing, stock bonus, pre-ERISA money purchase, or rural cooperative plan does not fail to satisfy the qualification requirements of §401(a) merely because the plan includes a nonqualified CODA.[1316] Whether or not such a plan remains qualified will depend upon whether, after treating the elective deferrals as nonelective employer contributions, any of the various tax-qualification rules have been violated. In testing whether the plan satisfies the nondiscrimination rules of §401(a)(4), the plan may not use the ADP and ACP tests of §401(k)(3) and §401(m)(2).[1317] However, if the CODA is nonqualified because it is part of an ineligible plan, then the entire plan will be disqualified for federal tax purposes.

[1310] Reg. §1.401(k)-1(a)(5)(iv)(A).
[1311] Reg. §1.401(k)-1(a)(3)(i), §1.401(k)-1(a)(5)(i).
[1312] Reg. §1.401(k)-1(e)(2)(i).
[1313] Reg. §1.401(k)-1(a)(3)(iii), §1.401(k)-1(a)(5)(i).
[1314] Reg. §1.401(k)-1(a)(5)(i).
[1315] Reg. §1.401(k)-1(a)(5)(iii), §1.402(a)-1(d)(1).
[1316] Reg. §1.401(k)-1(a)(5)(iv).
[1317] Reg. §1.401(k)-1(a)(5)(iv).

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X. History of §401(k)

A. CODAs Before 1974

1. Legal Issues Presented

a. Coverage and Discrimination

Qualified pension, profit-sharing, and stock bonus plans have historically been required to cover a broad group of employees. Before 1989, the Code's minimum coverage rules required a qualified plan to benefit either:

(1) 70% or more of all employees, or 80% or more of all the employees who were eligible to benefit under the plan if 70% or more of all the employees were eligible to benefit under the plan, excluding in each case employees who had not satisfied the plan's minimum age and service requirements; or

(2) a classification of employees that was found not to be discriminatory in favor of officers, shareholders, or highly compensated employees.[1318]

Qualified plans also historically have been prohibited from discriminating in favor of officers, shareholders, or highly compensated employees as to contributions or benefits provided under the plan.[1319] Discrimination for purposes of this provision was tested by looking only at contributions actually made to the trust, and not the total amounts that employees could elect to have contributed to the trust.[1320]

CODAs originally raised questions under both the coverage and nondiscrimination requirements because of the elective nature of contributions thereto. For example, if all employees were eligible to participate in a qualified profit-sharing plan, under which a bonus equal to 10% of pay would be contributed to a trust, and if 50% of the employees elected not to participate in the plan but to receive their 10% bonuses in cash instead, the plan would fail to satisfy the percentage coverage tests. If the 50% who chose to participate and have contributions made to the trust were predominantly shareholders, officers, and highly compensated employees, the coverage of the plan would probably fail to satisfy the nondiscriminatory classification test as well.

If all employees were included as participants and given the choice between cash and a trust contribution within the plan itself, the plan might be deemed to cover all employees and thus to satisfy the 70% coverage test. If, however, contributions were made to the trust only for the benefit of 50% of the participants, and if those participants were predominantly shareholders, officers, and highly compensated employees, the contributions under the plan might well be deemed to discriminate in favor of this prohibited group. Further, if the plan allowed all employees to elect to have any part or all of their profit-sharing allocation contributed to the trust, the contribution for each employee might represent a different percentage of pay. If contributions to the trust represented, on average, a significantly higher percentage of pay for shareholders, officers, and highly compensated participants than for other participants, the plan would again discriminate impermissibly in their favor.

[1318] Former §410(b)(1), as in effect before the 1986 TRA.

[1319] §401(a)(4).

[1320] *See* former Reg. §1.401-4(a)(1)(ii); Rev. Rul. 56-497.

b. Constructive Receipt

Under the doctrine of constructive receipt, amounts are included in gross income not only if received by an employee but also if made available to the employee.[1321] Since, under a CODA, an employee could choose between current receipt of cash and deferral under a qualified plan, the question originally arose as to whether the cash was made available to the employee, and therefore currently taxable, even if the employee elected to defer it.

Amounts are not deemed to be made available if the employee has made a prior irrevocable election to defer them.[1322] It is often unclear when that election must be made to avoid constructive receipt, however. The IRS will not rule on a nonqualified deferred compensation arrangement unless the election to defer is made before the period in which the amount deferred is earned.[1323] For example, if the deferral involves an annual bonus, the election must be made before the beginning of the year for which the bonus is awarded in order to obtain a ruling that the deferred bonus will not be currently taxable.[1324] On the other hand, some court decisions have been less restrictive.[1325]

2. Revenue Ruling 56-497

The coverage and discrimination issues described above were raised and answered in Rev. Rul. 56-497. That ruling discussed two profit-sharing arrangements under which employees could elect to take their share of profits in cash or have it contributed to the trust under the profit-sharing plan. Under one plan, employees had the additional option of taking one-half of the allocation in cash and deferring the other half by having it contributed to the trust. In applying the coverage requirements, the ruling treated each plan as covering only those employees who elected to have contributions made to the trust. The IRS ruled that one of the plans satisfied the nondiscriminatory classification test (set forth at the time in §401(a)(3)(B)), observing that over half of the participants in the trust were among the lowest paid two-thirds of all eligible employees. (The ruling

[1321] Reg. §1.451-2(a).

[1322] *See, e.g.*, *Goldsmith v. United States*, 586 F.2d 810 (Ct. Cl. 1978); *Oates v. Commissioner*, 18 T.C. 570 (1952), acq., 1960-1 C.B. 5, aff'd, 207 F.2d 711 (7th Cir. 1953); *Veit v. Commissioner*, 8 T.C. 809 (1947), acq., 1947-2 C.B. 4.

[1323] Rev. Proc. 92-64, Rev. Proc. 71-19. *See* Rev. Rul. 69-650 and Rev. Rul. 60-31.

[1324] In at least one private letter ruling, the IRS allowed deferral elections for annual bonuses to be made late in the year for which the bonuses would be awarded, where the amount of the bonus (if any) for each employee was uncertain at the time the elections were made, and the bonus would not be determined or paid until after the end of the year. *See, e.g.*, PLR 8150075. The IRS backed away, in general, from this ruling position and adhered more rigidly to Rev. Proc. 71-19. *See* Rev. Proc. 92-64. The enactment of §409A, which establishes mechanical timing rules for elections to defer compensation under a nonqualified deferred compensation plan, has largely mooted the issue in the context of nonqualified deferred compensation plans.

[1325] *See, e.g.*, *Martin v. Commissioner*, 96 T.C. 814 (1991); *Oates v. Commissioner*, 18 T.C. 570 (1952), acq., 1960-1 C.B. 5, aff'd, 207 F.2d 711 (7th Cir. 1953); *Olmsted Inc. Life Agency v. Commissioner*, 35 T.C. 429 (1960), nonacq., 1961-2 C.B. 6, aff'd, 304 F.2d 16 (8th Cir. 1962); *Veit v. Commissioner*, 8 T.C.M. 919 (1949).

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gave half weight to those employees who elected to have half of their profit-sharing allocation contributed to the trust.) Moreover, the plan was determined to be nondiscriminatory because the participants who elected to have their full profit-sharing allocations contributed to the trust were allocated those contributions in proportion to their basic annual salaries, and similar allocations were made for those who participated to the extent of half their allocations.

Note: The approval of the coverage of one of the profit-sharing plans in Rev. Rul. 56-497 was tantamount to approving a 2:1 ratio of discrimination in favor of the highest paid one-third of the employees, as illustrated by the following example:

> *Example:* If the total amount available under a cash or deferred profit-sharing plan equals 10% of pay, and all of the highest paid one-third of the eligible employees elect to have their contributions made to the trust, the average contribution for these employees will be 10%. If one-half of the lowest paid two-thirds of the eligible employees take cash and one-half elect contributions to the trust, the plan will have adequate coverage under Rev. Rul. 56-497. The average trust contribution for these lower paid employees will be 5%. The higher paid employees are favored, on average, by a 2:1 ratio, 10% to 5%. Compare the 1.25-to-1 and 2-to-1 discrimination ratios permitted after 1986 by §401(k)(3).[1326]

Rev. Rul. 56-497 did not address the issue of constructive receipt. The plan approved by the ruling, however, did require an irrevocable election before the close of the calendar year for which the profit-sharing contributions would be made. This was evidently assumed to be sufficient to avoid constructive receipt, perhaps because the employer's profits, and the portion available to each participant, would not be determined or made available to participants until after the end of the year.

3. *Subsequent Cases and Rulings*

In *Hicks v. United States*,[1327] involving a profit-sharing plan similar to the plan approved in Rev. Rul. 56-497, a federal district court held that amounts contributed to the trust were currently taxable to the employees, to the extent the employees could have elected to receive those amounts in cash. Under the plan in question, 40% of the annual profit-sharing contribution was automatically paid to the trust. The remaining 60% was paid in cash, except that employees with two or more years of service could elect by December 1 of the year for which the profits were computed to have their shares paid to the trust. The court applied the principle of *Helvering v. Horst*,[1328] and determined that employees had constructively received the 60% portion of the profit-sharing contribution that they could have received in cash.

In Rev. Rul. 63-180, the IRS reaffirmed Rev. Rul. 56-497, distinguishing *Hicks* and confining it to its facts. The ruling distinguished *Hicks* on the ground that the 60% portion of the profit-sharing contribution was, if contributed to the profit-sharing trust, expressly treated by the plan "as if it had been paid by such employee."[1329] This 60% portion was also reflected in a separate account, and was subject to more liberal vesting and withdrawal rules. Thus, the IRS concluded that the 60% portion, when contributed to the trust, was an employee contribution "both in form and in substance," and therefore could be currently taxed on that basis. Rev. Rul. 56-497 was distinguished on the ground that it involved only employer contributions, even though they were made to the trust only at the employee's individual option.

Rev. Rul. 63-180 also squarely addressed the constructive receipt question that was resolved only implicitly in Rev. Rul. 56-497. Rev. Rul. 63-180 stated that, in cases like that described in Rev. Rul. 56-497, "the employer's contribution on behalf of an employee is not includible in the employee's gross income at the time the contribution is made."[1330]

In Rev. Rul. 68-89, the IRS reconfirmed Rev. Rul. 56-497 and Rev. Rul. 63-180, ruling that elective contributions under a profit-sharing plan similar to that approved in Rev. Rul. 56-497 were employer contributions not only for federal income tax purposes but also for federal estate tax purposes — in particular, for the exclusion from a decedent's gross estate available under former §2039(c) for qualified plan benefits attributable to employer contributions.

Thus, until late 1972, the IRS's position was clear that a CODA could be established as part of a profit-sharing plan, under which each eligible employee could elect to receive part or all of his or her profit-sharing allocation in cash or have it paid to the trust on a tax-deferred basis, provided the following conditions were met:

> (1) The election was irrevocable, and was made before the end of the year for which the profits were to be determined;
>
> (2) Over half of the participants in the trust were among the lowest paid two-thirds of all eligible employees, giving partial weight to those electing to defer only a portion of the deferrable amount; and
>
> (3) The elective contributions were treated by the plan as employer contributions and subject to the same restrictions on withdrawals or distributions as other employer contributions under the plan (or under qualified plans generally).

While the foregoing rulings dealt only with CODAs involving annual profit-sharing bonuses payable in addition to normal salary, many employers instituted CODAs under which employees could elect to reduce their normal salary and have the amount of the reduction paid to the qualified trust. Moreover, the salary reduction arrangements were not limited to profit-sharing plans, but were included in money purchase pension plans as well.

4. *Proposed Salary Reduction Regulation*

On December 6, 1972, the IRS issued a proposed regulation which provided that a contribution to a qualified plan would be treated as an employee contribution if it was made at the election of the employee "in return for a reduction in his basic or regular compensation or in lieu of an increase in

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[1326] *See* II.C.3.a., above.
[1327] 205 F.Supp. 343 (W.D. Va. 1962).
[1328] 311 U.S. 112 (1940).
[1329] Rev. Rul. 63-180.
[1330] Rev. Rul. 63-180.

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such compensation."[1331] The proposed regulation would therefore have taxed these salary reduction contributions as if they had actually been received by the employee. While the proposed regulation did not address CODAs involving bonuses or other amounts paid in addition to normal salary, it cast doubt on these arrangements because of the conceptual difficulties in distinguishing between salary reduction elections and elections as to other portions of an employee's available cash compensation. According to a 1974 House Ways and Means Committee report, there were indications that Rev. Rul. 56-497, Rev. Rul. 63-180, and Rev. Rul. 68-89 would be reconsidered in connection with the proposed salary reduction regulation.[1332]

B. ERISA Moratorium

1. Plans in Existence on June 27, 1974

Section 2006(b) of the Employee Retirement Income Security Act of 1974 (ERISA)[1333] prohibited the Treasury Secretary from issuing any salary reduction regulations in final form before January 1, 1977, with respect to any arrangement that was in existence on June 27, 1974, and which provided for contributions to a qualified trust described in §401(a), §403(a), or §405(a), or which permitted an employee to elect to receive part of his or her compensation in one or more alternative forms if one of the forms resulted in the inclusion of amounts in income under the Code. Moreover, when the regulations became final, they could not have an effective date before January 1, 1977, for income tax purposes, or before the date of issuance in final form for FICA and withholding tax purposes.[1334]

ERISA §2006(e) defined "salary reduction regulations" to mean:

> regulations dealing with the includibility in gross income (at the time of contribution) of amounts contributed to a [qualified] plan … if the contribution is made … only if the employee elects to receive a reduction in his compensation or to forego an increase in his compensation, or under an arrangement under which the employee is permitted to elect to receive part of his compensation in one or more alternative forms (if one of such forms results in the inclusion of amounts in income under the … Code …).[1335]

Under ERISA §2006(c), the law with respect to the protected plans or arrangements in existence on June 27, 1974, was to be administered in the same manner as before January 1, 1972, and without regard to the proposed salary reduction regulation issued by the IRS on December 6, 1972.[1336] With respect to profit-sharing plans with cash or deferred features, ERISA §2006(c)(2) mandated that the law be administered consistently with Rev. Rul. 56-497, Rev. Rul. 63-180, and Rev. Rul. 68-89.

While the main thrust of ERISA §2006(b) was to prevent the IRS from issuing its 1972 proposed salary reduction regulation in final form before the end of 1976, the language of ERISA §2006 and its legislative history clearly indicated that the temporary moratorium was to protect CODAs involving bonuses or other amounts payable in addition to normal salary, as well as salary reduction plans. The purpose of the moratorium was to allow time for Congress to study these types of plans.[1337]

2. Plans Not in Existence on June 27, 1974

Under ERISA §2006(a), which applied to plans not in existence on June 27, 1974, any contribution during the temporary moratorium (i.e., before January 1, 1977) under a salary reduction or other CODA forming part of a qualified plan, or under a cafeteria plan, was to be treated as an employee contribution, and therefore currently includible in the employee's income, "only if the employee [in making the contribution] elect[ed] to receive a reduction in his compensation or to forego an increase in his compensation."[1338] Thus, while ERISA §2006 protected plans in existence on June 27, 1974, from the impact of the 1972 proposed salary reduction regulation, ERISA §2006(a) actually gave that proposed regulation the force of law with respect to new plans established after June 27, 1974.

3. Extension of Moratorium

The January 1, 1977, date on which the ERISA moratorium was to expire was extended twice; once to January 1, 1978, by the Tax Reform Act of 1976,[1339] and then to January 1, 1980, by the Tax Treatment Extension Act of 1978.[1340] In July 1978, the IRS withdrew its 1972 proposed salary reduction regulation.[1341]

C. Enactment of §401(k) and §402(a)(8)

The congressional study envisioned by the ERISA moratorium on salary reduction and similar plans culminated in the enactment of §401(k) and §402(a)(8) in the Revenue Act of 1978.[1342]

Section 401(k) provides, in general, that a profit-sharing or stock bonus plan will not fail to qualify under §401(a) merely because it includes a qualified CODA and sets forth the requirements that apply to qualified CODAs. Section 402(a)(8) (now §402(e)(3), as amended) provides that contributions to a qualified trust at an employee's election under a qualified CODA will be treated as employer contributions and will not be subject to federal income tax at the time the contributions are made. Both provisions became effective for plan years beginning after December 31, 1979.[1343] For plan years beginning before January 1, 1980, Rev. Rul. 56-497, Rev. Rul. 63-180, and Rev. Rul. 68-89 were to govern CODAs in existence on June 27, 1974.[1344] These rulings, however, were declared obsolete for subsequent plan years.[1345]

[1331] *See* former Prop. Reg. §1.402(a)-1(a)(1)(i), 37 Fed. Reg. 25,938 (Dec. 6, 1972).

[1332] H.R. Rep. No. 779, 93d Cong., 2d Sess. 141 (1974).

[1333] Pub. L. No. 93-406, §2006(b).

[1334] Pub. L. No. 93-406, §2006(d).

[1335] Pub. L. No. 93-406, §2006(e).

[1336] Pub. L. No. 93-406, §2006(c).

[1337] H.R. Rep. No. 1280, 93d Cong., 2d Sess. 355 (1974).

[1338] Pub. L. No. 93-406, §2006(a).

[1339] Pub. L. No. 94-455, §1506.

[1340] Pub. L. No. 95-615, §5.

[1341] 43 Fed. Reg. 30,308 (July 14, 1978).

[1342] Pub. L. No. 95-600, §135(a). Section 402(a)(8) was later redesignated §402(e)(3).

[1343] Pub. L. No. 95-600, §135(c)(1).

[1344] Pub. L. No. 95-600, §135(c)(2).

[1345] Rev. Rul. 80-16.

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