

Reconciliation Act of 2001, Public Law 107-16 (115 Stat. 38) (EGTRRA).

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

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

Prior to the enactment of SBJPA, sections 401(k) and 401(m) provided only for mathematical comparison. Specifically, the ADP and ACP tests compare the average of the rates of contributions of the HCEs to the average

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

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

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

- The ADP test and ACP test were amended to allow the use of prior year data for NHCEs.
- The method of distributing to correct failures of the ADP test or ACP test was changed to require distribution to the HCEs with the highest contributions.
- Tax-exempt organizations and Indian tribal governments are permitted to maintain section 401(k) plans.
- A safe harbor alternative to the ADP test and ACP test was introduced in order to provide a design-based method to satisfy the nondiscrimination tests.
- The SIMPLE 401(k) plan (an alternative design-based method to satisfy the nondiscrimination tests for small employers that corresponds to the provisions of section 408(p) for SIMPLE

IRA plans by providing for smaller contributions) was added.

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

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

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

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

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

- The multiple use test specified in section 401(m)(9) is repealed.

- Faster vesting is required for matching contributions.
- Matching contributions are taken into account in satisfying the top-heavy requirements of section 416.

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

- Notice 97-2 (1997-1 C.B. 348) provided initial guidance on prior year ADP and ACP testing and guidance on correction of excess contributions and excess aggregate contributions, including distribution to the HCEs with the highest contributions.
- Rev. Proc. 97-9 (1997-1 C.B. 624) provided model amendments for SIMPLE 401(k) plans.