

would not challenge the deductibility of the contributions provided actual payment is made during the taxable year for which the deduction is claimed and the amount deducted does not exceed the applicable limit under section 404(a)(3)(A)(i). After considering this issue, the IRS and Treasury have concluded that the prefunding of elective contributions and matching contributions is inconsistent with sections 401(k) and 401(m). Thus, under these proposed regulations, an employer would not be able to prefund elective contributions to accelerate the deduction for elective contributions. Once these regulations are finalized, employer contributions made under the facts in Notice 2002-48 would no longer be permitted to be taken into account under the ADP test or the ACP test and would not satisfy any plan requirement to provide elective contributions or matching contributions.

2. Qualified CODAs

A. General Rules Relating to Qualified CODAs

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

A CODA is not qualified unless it is part of a profit sharing plan, stock bonus plan, pre-ERISA money purchase plan, or rural cooperative plan and provides for an election between contributions to the plan or payments directly in cash. In addition, a CODA is not qualified unless it meets the following requirements: (1) The elective contributions under the CODA satisfy either the ADP test set forth in section 401(k)(3) or one of the design-based alternatives in section 401(k)(11) or (12); (2) elective contributions under the CODA are nonforfeitable at all times; (3) elective contributions are distributable only on the occurrence of certain events, including attainment of age 59½, hardship, death, disability, severance from employment, or termination of the plan; (4) the group of employees eligible

to participate in the CODA satisfies the coverage requirements of section 410(b)(1); (5) no other benefit (other than matching contributions or another specified benefit) is conditioned, directly or indirectly, upon the employee's making or not making elective contributions under the CODA; and (6) no more than 1 year of service is required for eligibility to elect to make a cash or deferred election.

Subject to certain exceptions, State and local governmental plans are not allowed to include a qualified CODA. Plans sponsored by Indian tribal governments and rural cooperatives are allowed to include a qualified CODA.

B. Nondiscrimination Rules Applicable to CODAs

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

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

These proposed regulations are designed to provide simple, practical rules that accommodate legitimate plan changes. At the same time, the rules are intended to be applied by employers in a manner that does not make use of changes in plan testing procedures or other plan provisions to inflate inappropriately the ADP for NHCEs (which is used as a benchmark for testing the ADP for HCEs) or to otherwise manipulate the nondiscrimination testing requirements of section 401(k). Further, these nondiscrimination requirements are part of the overall requirement that benefits

or contributions not discriminate in favor of HCEs. Therefore, a plan will not be treated as satisfying the requirements of section 401(k) if there are repeated changes to plan testing procedures or plan provisions that have the effect of distorting the ADP so as to increase significantly the permitted ADP for HCEs, or otherwise manipulate the nondiscrimination rules of section 401(k), if a principal purpose of the changes was to achieve such a result.

C. Aggregation and Disaggregation of Plans

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

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