

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

The proposed regulations would retain the existing rules relating to the section 401(k)(4)(A) prohibition on having benefits (other than a match) contingent on making or not making an elective contribution. However, the proposed regulations would specify that, in the case of a benefit that requires an amount to be withheld from an employee's pay, an employer is not violating the section 401(k)(4)(A) contingent benefit rule merely because the CODA restricts elective contributions to amounts available after such withholding from the employee's pay (after deduction of all applicable income and employment taxes). In addition, these proposed regulations also reflect the amendment to section 416(c)(2)(A) under which matching contributions can be taken into account for purposes of satisfying the top-heavy minimum contribution requirement without violating the prohibition on making benefits contingent on making or not making elective contributions.

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

As under the existing final regulations, these proposed regulations would provide that a partnership is permitted to maintain a CODA, and individual partners are permitted to make cash or deferred elections with

respect to compensation attributable to services rendered to the entity, under the same rules that apply to common-law employees. This rule has been extended to sole proprietors. The provisions of these regulations also reflect the enactment of section 402(g)(8) (initially section 402(g)(9) as enacted by TRA '97) providing that matching contributions with respect to partners and sole proprietors are no longer treated as elective contributions.

3. *Nonqualified CODAs*

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

4. *The Actual Deferral Percentage (ADP) Test*

A. General Rules Relating to the ADP Test

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

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

Section 401(k)(3)(F), as added by SBJPA, provides that a plan benefitting otherwise excludable employees and

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

B. Elective Contributions Used in the ADP Test

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

Section 401(k)(3) provides that the actual deferral ratio (ADR) of an HCE who is eligible to participate in 2 or more CODAs of the same employer is calculated by treating all CODAs in which the employee is eligible to participate as one CODA. The existing regulations implement this rule by aggregating the elective contributions of