

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

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

C. Additional Employer Contributions Used in the ADP Test

The proposed regulations would generally retain the rules in the existing regulations permitting a plan to take qualified nonelective contributions or qualified matching contributions (*i.e.*, nonelective or matching contributions that satisfy the vesting and distribution limitations of section 401(k)(2)(B) and (C)) into account under the ADP test, except as described below. Thus, an employer whose CODA has failed the

ADP test can correct this failure by making additional qualified nonelective contributions (QNECs) or qualified matching contributions (QMACs) for its NHCEs. The proposed regulations would no longer describe such contributions as being treated as elective contributions under the arrangement, but would nonetheless permit such contributions to be taken into account under the ADP test.

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

Some plans provide a correction mechanism for a failed ADP test that targets QNECs to certain NHCEs in order to reduce the total contributions to NHCEs under the correction. Under the method that minimizes the total QNECs allocated to NHCEs under the correction, the employer makes a QNEC to the extent permitted by the section 415 limits to the NHCE with the lowest compensation during the year in order to raise that NHCE's ADR. If the plan still fails to pass the ADP test, the employer continues expanding the group of NHCEs who receive QNECs to the next lowest-paid NHCE until the ADP test is satisfied. By using this bottom-up leveling technique, the employer can pass the ADP test by contributing small amounts of money to NHCEs who have very low

compensation for the plan year (for example, an employee who terminated employment in early January with \$300 of compensation). This is because of the fact that the ADP test is based on an unweighted average of ADRs and a small dollar (but high percentage of compensation) contribution to a terminated or other partial-year employee has a larger impact on the ADP test than a more significant contribution to a full-year employee.

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

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

This restriction on targeting QNECs would be implemented in the proposed regulations by providing that a QNEC that exceeds 5% of compensation could be taken into account for the ADP test only to the extent the contribution, when expressed as a percentage of compensation, does not exceed two times the plan's representative contribution rate. The plan's representative contribution rate would be defined as the lowest contribution rate among a group of NHCEs that is half of all the eligible NHCEs under the arrangement (or the lowest contribution rate among all eligible NHCEs under the arrangement who are employed on the last day of the year, if greater). For purposes of determining an NHCE's contribution rate, the employee's qualified nonelective contributions and

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